• Adoption of a more comprehensive strategy for reform of the tax and transfer system that leads quickly to incremental changes in the current system to promote stronger private-sector growth.

The Institute's recommendations reflect the conclusion that emerges from its detailed analysis of the issues: if Canada is to harness the powerful forces of change at work in the world economy, it will have to adopt policies that improve its ability to adjust — that is, to reallocate labor and capital resources in response to changing economic conditions.

Risks of the Status Quo

Chapter 1 analyzes international and domestic economic developments in 1985. It points out Canada's continuing need to adjust to changes in technology, to shifts in international competitiveness, and to uncertainty about the stability of the world trade and financial systems. The international environment has been favorable — with the major exception of growing protectionist sentiment in the United States, caused by a strong U.S. dollar that has battered U.S. exports and producers competing with imports.

In an effort to stem the rising tide of U.S. protectionism, senior officials of the five largest industrial nations met in September 1985 and engineered a dramatic decline in the dollar's value. The strong-dollar psychology was broken, at least temporarily. But fundamental policy shifts are needed that address the causes of the strong dollar — the large budget deficit in the United States and slow growth in Japan and West Germany. Without such changes, the risk is that in the longer term, little will have been accomplished other than replanting the seeds of U.S. inflation. Attempts in late 1985 to cut the U.S. deficit by imposing a legal requirement to balance the budget by 1990 suggested, however, that the budget process was in serious difficulty. Only a binding rule seemed to show any promise of breaking the political standoff over how to cut the U.S. deficit.

Canada has experienced stronger economic growth since mid-1984 than every other major industrial country but Japan. The improvement has been broadly based but important imbalances remain. Business investment, while improving, remains at a low level. Unemployment remains high even while industrial capacity is more fully used; regional imbalances in economic activity persist, a fact underscored by the failures of two western Canadian banks.

The Institute concludes that with the important exceptions of changes in energy and foreign investment policies, very little progress has been made in 1985 in moving away from the status quo. Some important groundwork has been laid, however, that could lead to significant progress in 1986. A start has been made to reduce the federal budget deficit, but not enough to stop or reduce the accumulation of debt. Without further action, the deficit will remain in the $25—35 billion range and federal debt will continue to grow faster than the economy's ability to service it. Proposed negotiations

on a comprehensive trade agreement with the United States have to get under way in 1986 if Canada is to escape the consequences of U.S. protectionism and improve its international competitive position.

Sharpening Canadians' Economic Self-Image

Chapter 2 assesses recent evidence on economic adjustment and the job-generation process in Canada. The Canadian economy is often perceived as being one in which industrial change occurs only gradually. This image generates the unfortunate attitude — on which policy is often based — that changes in technology and shifting international comparative advantage are necessarily harmful to Canada. The evidence suggests, however, that the image of gradual change is false; that even with existing policies which slow adjustment, dynamic change is the norm in Canada's private sector.

High turnover rates in the labor market and among businesses are ample evidence of this change. It is estimated, for example, that nearly one-half of all Canadians who worked in 1984 changed their employment status at least once during the year, while new business startups now account for more than twice as many new jobs as expansions of existing firms. Furthermore, small firms, especially those in the services sector, have been the primary engine of job creation in recent years — accounting for approximately 85 percent of the net new jobs created.

This evidence has fundamental significance for economic policy. It suggests that since change is both inevitable and an ongoing process in the Canadian economy, removing obstacles to this inherent dynamism is one way of improving the economy's ability to adjust. This means relying less on policies — such as import restrictions, bailouts, and subsidies to marginal industries — that shield firms or industries from inevitable adjustment. It also suggests that the economy is more able to adjust to gradual changes in trade and tax policies than is often claimed by those who favor the status quo.

High Stakes: A Canadian-U.S. Trade Agreement

While the risks posed by the status quo represent a major motivation for bilateral trade negotiations, there are longer-term strategic reasons for pursuing this goal. Chapter 3 examines the environment for the negotiations and explores the key negotiating issues.

Changes in the world trading environment — including rising import competition from the newly industrializing countries, the strength of the U.S. dollar, and protectionist threats to reduce access to export markets — have created pressures for all major trading nations. Canada's decision to pursue a bilateral trade agreement reflects its intention of dealing with these global pressures by gradually opening the Canadian economy to increased competition within the North American market. The rationalization needed to improve the competitiveness of Canadian industry will be less disruptive if it occurs in an environment of growth made possible by the gradual dismantling of U.S. and Canadian trade barriers.

Two more recent trends in the world trading environment have greatly increased Canadian interest in a bilateral trade agreement. First, the rise of protectionism worldwide signals a breakdown of the liberal trade principles and rules established under the General Agreement on Tariffs and Trade (GATT). The increasing use of nontariff barriers to trade is the major cause of the breakdown — particularly the increased resort to measures such as "voluntary export restraints" and other informal market-sharing agreements between trading partners. The use of these measures is difficult to control because industries in both exporting and importing countries share the higher profits that protection creates. Yet their use weakens the commitment to international trade rules and the basic GATT principle of nondiscrimination.

Second, rising protectionist sentiment in the United States — manifested in numerous protectionist bills before Congress — seriously threatens Canada's economic prospects. Some of these bills, aimed at Japan, could spark a trade war that would damage growth in both of Canada's largest trading partners. Others directly threaten Canadian exports of lumber and other resource products to the United States.

The surge of Canadian-U.S. trade since 1983 has benefited Canada greatly, but it has also led to increased bilateral trade disputes and increased Canadian vulnerability to shifts in U.S. trade policy. In 1984 and 1985, U.S. trade actions threatened Canadian exports of 12 commodities with a total value of $7 billion. An examination of the threat posed to three of them — steel, lumber, and fish — indicates that the pressures will not go away and that they could compound the economic problems of British Columbia and the Atlantic region, where unemployment is already high.

Another contentious bilateral issue in 1985 concerned Canada's new policy toward foreign investment in the book-publishing industry. The issue became controversial because of the U.S. perception that, as was the case with the National Energy Program, Canada had retroactively changed the rules governing foreign investment in this culturally sensitive sector.

The Institute's assessment of the key negotiating issues indicates that if Canada and the United States wish to gain freer and more secure access for their exports and investment in the other country, both will have to accept limits on the way they apply their trade, investment, and industrial policies. There is considerable confusion, however, about what issues will be "on the table". The tendency by both countries to take issues or industries off the table before discussions begin limits the scope for a mutually beneficial agreement. A better approach would be to begin discussions with most issues on the table but to define policies that do not restrict trade or investment — such as those serving broad social and cultural objectives — and exclude them from the negotiations.

A number of key issues are likely to be the subject of intense negotiation. As the smaller partner, Canada has the most at stake. Its negotiating strategy and objectives, therefore, will be of utmost importance in seeking an agreement that meets its economic objectives and that preserves its cultural and political interests. Both countries will have to assess the issues that will

arise and be prepared to make tradeoffs. These issues will include a timetable for reducing tariffs; bilateral rules governing such nontariff barriers as countervailing duties; the use of subsidies; the treatment of foreign investment; government procurement policies; and specific industrial issues — particularly those relating to agriculture, cultural industries, and services.

If Canada is to achieve its main objectives — relief from future application of U.S. countervail and other trade laws and a slower phaseout of Canadian tariffs — it can expect to be asked to limit its use of industrial subsidies, to explore the removal of barriers to trade in services, and to further limit the screening of foreign takeovers. If the United States refuses to limit application of its trade laws, the benefit to Canada of negotiating the removal of other trade barriers will be limited. If an agreement to reduce tariff and nontariff barriers to trade and investment can be reached, both countries will benefit.

To strengthen Canada's bargaining position, Canadian negotiators should coordinate their objectives in bilateral negotiations with future GATT negotiations. If an acceptable bilateral agreement cannot be reached, Canada should seek enhanced and more secure access to world markets through the multilateral process.

Rewarding Initiative: Reform of the Tax and Transfer System

Chapter 4 examines the central role that the tax and transfer system can play in achieving the strategic objective of stronger private-sector growth. The current system does not contribute to stronger growth because it contains important disincentives to work, save, and invest. The chapter analyzes the distortions caused by the current system and assesses two routes to reform.

Individuals and firms make important decisions based on incentives created by the tax and transfer system: they are encouraged to alter their behavior to reduce the amount of tax they have to pay or to increase the benefits they receive from transfer payments. Over the years, transfer payments and tax policy have evolved independently. The result has been an *ad hoc* accumulation of transfers and tax provisions that discourage economic efficiency and growth.

The current system discourages saving and encourages individuals and firms to base investment decisions more on tax considerations than on the underlying productivity of the investment. It penalizes work both because the large value of deductions, exemptions, and credits means that tax rates must be increased and because many transfer programs contain important disincentives to work. Features of the current system also contribute to a structural imbalance between federal revenues and expenditures that worsens the budget deficit. Finally, to the average taxpayer or transfer recipient, the system appears complex and often unfair.

While the flaws in the current system are widely recognized, sweeping changes take time. Because the issues are complex and the financial impact

on individuals and firms potentially large, the wisest strategy is to introduce change incrementally. In making such incremental changes, it is critically important to keep in focus a comprehensive strategic view of the objectives that tax reform is expected to promote. In 1985, two such comprehensive strategies for reform have been proposed.

One proposal, by the government of Quebec, recommends a major integration of that province's tax and transfer system to eliminate overlap of social benefits and tax provisions and to reduce marginal tax rates at all levels. The key element of the proposal is a form of guaranteed annual income that would rationalize the system so that each individual is either paying income taxes or receiving a transfer but not both at the same time. Quebec's approach would reduce the current system's inherent disincentives to work, as well as making it simpler and fairer.

A second proposal, by the Macdonald Commission, focuses attention on features of the current system that unnecessarily detract from long-term growth. The Commission's recommendations have two key elements. The first is to encourage saving and investment by gradually redefining the personal and corporate tax bases as personal consumption and corporate cash flow rather than as income. The move toward taxing consumption rather than income would be achieved by simply exempting all savings from tax, no matter how they are invested, and by simultaneously eliminating existing *ad hoc* income-tax provisions designed to encourage saving. The second element is to replace most of the existing structure of federal social transfers with a single guaranteed annual income called a Universal Income Security Program (UISP). Unlike Quebec's, however, the Macdonald Commission's proposal fails to spell out how basic personal tax exemptions and deductions would be affected by moving to a consumption base and how they would be integrated with a UISP.

Taken together, the Quebec and Macdonald Commission proposals provide a comprehensive framework for thinking about reform. But while they address the fundamental problems of the existing system, they represent major changes in the status quo that could not be made overnight. Nevertheless, their comprehensive approach provides a useful benchmark against which changes to the system can be assessed.

The federal government is, in fact, considering changes. These are motivated partly by a desire to reduce distortions caused by the current system. But they are also a response to lobbying by special-interest groups and to the government's need for more revenue. The proposed minimum personal tax, for example, is an attempt to address public concerns that the burden of deficit reduction be distributed widely and that some high-income individuals are able to shelter virtually all of their income from tax. Unfortunately, a minimum tax would add to the complexity of the tax system and discourage initiative by raising marginal tax rates for high-income individuals. If a minimum tax must be imposed — to build support for deficit reduction — it should remain in place only until the personal tax provisions that reduce taxable income have been evaluated. If those that no

longer serve appropriate goals were eliminated, there would be no need for a minimum tax.

The federal government is also studying the replacement of the existing manufacturers' sales tax (MST) with a value-added tax (VAT). A VAT is like a national sales tax that is levied on the value added at each stage of production of all goods and services. The advantage of a VAT is that it would reduce both the administrative complexity and the arbitrary, but costly, distortions of the MST. The primary disadvantage of a VAT is that, by providing a potentially rich source of new revenue, it would reduce pressures for efficiency in government and distract attention from the more fundamental problems of the tax and transfer system.

A third candidate for reform is the corporate income tax. Of the three tax-reform options under consideration, the corporate-tax proposal is the most capable of reducing some of the problems inherent in the existing system. By eliminating the investment tax credit and reducing rapid writeoffs of certain types of equipment, the proposal would eliminate the wide differences that currently exist in effective tax rates across industries and regions. By adopting a more internationally competitive system for transferring business losses and deductions within corporate groups, it could help mobilize Canadian savings for investment and growth. Yet, it too is primarily an attempt to respond to the external pressures of U.S. tax reform and to the internal instability of the existing system. Furthermore, by introducing new uncertainty about the future corporate tax, it could reduce investment in equipment at a time when Canada is challenged to improve its productivity and international competitiveness.

Our assessment of the problems with the tax and transfer system suggests that a more comprehensive strategy for reform is required. The Quebec and Macdonald Commission proposals provided important new building blocks. To ignore them would be short-sighted indeed.

Reorienting the Canadian Economy

The concluding chapter presents the Institute's strategic framework for economic policy in 1986. One important constraint policymakers face is uncertainty about the international economic environment. The combination of lower interest rates and lower oil prices will provide a basis for stronger growth in the industrial countries in 1986. But imbalances in fiscal policies in the major industrial nations, the spread of protectionism, and the persistent international debt problem all pose major risks that could throw the world economy into recession.

Canadian policymakers would be well advised to take account of the growing importance of global interdependence: the impact of adverse international developments could be even more serious if Canadian policy does not change to facilitate adjustment. Canada's short-term economic prospects, however, are good. Now is the time to take the tough decisions needed to ensure more balanced and sustainable growth.

The Institute believes that a strategy to promote adjustment in order to achieve faster, noninflationary growth should consist of three elements: a Canadian-U.S. agreement to reduce bilateral trade barriers, additional steps to reduce the federal deficit, and a comprehensive approach to removing distortions created by the existing tax and transfer system.

Canadian-U.S. Trade Negotiations

Canada's economic objectives in trade negotiations with the United States will be to gain more secure access to the U.S. market and to improve the competitiveness of Canadian industry. But Canadian negotiators also will have to ensure that a trade deal does not compromise Canada's political and cultural independence and that policies are in place to spread the burden of adjustment to freer trade.

The most important Canadian objective in the negotiations — more secure access to the U.S. market — will also be the toughest to negotiate. In its negotiations with other countries, the United States has refused to accept restraints on its trade laws. But a compromise that limits the negative impact of U.S. trade laws on Canada should be possible. The Institute recommends:

- that Canada seek to negotiate a trade agreement that includes the gradual elimination of bilateral tariffs, as well as a formula for restricting the damaging and unpredictable application of U.S. trade laws on Canada's exports; and,
- that, to achieve its objectives, Canada be prepared to respond to U.S. concerns about the retroactive application of rules governing foreign investment and to examine its industrial subsidies and government-procurement practices at both the federal and provincial levels.

The question of what issues and industries should be on the table in the negotiations is an important one. Negotiators from both sides would be well advised to hold exploratory discussions to identify and separate policies that distort trade and investment flows from those that do not. The Institute recommends:

- that Canadian negotiators clearly identify policies that do not restrict trade — including generally available social policies such as unemployment insurance and health care, as well as those that directly encourage Canadian culture — and remove them from the negotiations.

Finally, if an agreement is reached, federal and provincial governments will have to attach considerable importance to spreading the burden of the necessary adjustments. The Institute recommends:

• that Canadian governments adopt more effective adjustment assistance programs to assist individuals who are displaced when firms rationalize operations as bilateral trade barriers decline.

Deficit Reduction

The rapid accumulation of federal debt still has to be reduced. Budget actions taken in 1984 and 1985 delayed a potential fiscal crisis, but unless additional action is taken, the public debt will continue to grow faster than the economy's ability to service it. As long as Canada's debt problem continues to grow, federal fiscal policy remains vulnerable to unexpected increases in international interest rates. Large federal borrowing requirements will also absorb a high proportion of Canadian savings and prevent the Bank of Canada from lowering interest rates as much as it otherwise would.

Based on its analysis of deficit-reduction actions taken so far and of the task that remains, the Institute recommends:

• that the federal government aim to slow the growth of the debt to less than that of the economy so that the debt-to-GNP ratio begins to fall by 1990. Achieving this target will require at least $10 billion in additional deficit cuts by 1990;
• that the instruments of deficit reduction focus on the expenditure side of the budget. These measures should include: moving ahead proposed reductions in transfers to the provinces; implementing the recommendations of the Ministerial Task Force on Program Review; making further cuts in industrial subsidies, including a moratorium on new commitments; reforming the unemployment insurance system and using the savings to fund a more effective adjustment assistance program; and eliminating tax expenditures that no longer serve intended objectives.

Reform of the Tax and Transfer System

Reducing disincentives to work, save and invest is an important prerequisite of improved efficiency and growth in the private sector. Analysis of the current system leads the Institute to conclude that it is badly flawed. Some changes under consideration by the federal government could help mobilize Canadian savings for stronger productive investment. But these proposals would do little to integrate the personal tax and transfer system or remove the major distortions it creates. The Institute recommends:

• that the federal government adopt a more comprehensive approach to reform. This approach could include the Macdonald Commission's proposal to shift taxation toward a consumption base, and the Quebec government's proposal to rationalize and fully integrate the tax system with a redesigned system of income-security transfers.

Reorienting the Canadian economy is a task that will require all of the principal actors in the policymaking process — federal and provincial governments, business, and labor unions — to turn recommendations into action. If they can do this, 1986 could be a year of unique accomplishment in securing Canada's long-term growth prospects.

Summary

Reorienting the Canadian Economy

Policy Review and Outlook, 1986

Edward A. Carmichael

Major changes in economic policy that encourage adjustment to a rapidly changing world economy are needed in 1986 if Canada is to avoid second-rate economic performance in the future. The chances of becoming second rate in the long term are very real, because the policy choices that will lead to this outcome are the comfortable ones that sustain the short-term status quo.

The C.D. Howe Institute's *Policy Review and Outlook* focuses on three policy areas in which the risks of continuing with the status quo are high. First, Canada's trade policy is no longer sustainable in a turbulent and increasingly competitive world. Second, the rapid accumulation of federal debt associated with large budget deficits increases Canada's vulnerability to unexpected increases in interest rates and threatens to restrain investment and job creation in the private sector. Third, the existing tax and transfer system creates disincentives to work, save, and invest that act as another obstacle to improved economic growth.

The Institute concludes, therefore, that a strategy to achieve more balanced and sustainable growth across industries and regions of the country should include three significant changes in the status quo beginning in 1986:

- Negotiation of a comprehensive trade agreement with the United States that serves Canada's economic objectives — gaining secure access to the U.S. market and improving the competitiveness of Canadian industry — and that protects its cultural and political interests.
- Adoption of additional measures to reduce the federal deficit by at least $10 billion by 1990 in order to reduce the risks associated with rapid debt accumulation.

Reorienting the Canadian Economy

Policy Review and Outlook, 1986

C.D. Howe Institute

Edward A. Carmichael

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C.D. Howe Institute

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The Institute was created in 1973 by a merger of the C.D. Howe Memorial Foundation and the Private Planning Association of Canada. The Foundation had been created in 1961 to memorialize the late Right Honourable C.D. Howe, who served Canada in many elected capacities between 1935 and 1957, including as Minister of Trade and Commerce. The Private Planning Association of Canada was a unique forum created in 1958 by leaders of business and labor for the purpose of carrying out research and educational activities on economic policy issues.

While its focus is national and international, the Institute recognizes that Canada is composed of regions, each of which may have a particular perspective on policy issues and different concepts of what should be national priorities.

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Michel Bélanger is Chairman, Wendy Dobson is Executive Director and Treasurer, and Christine Leadman is Corporate Secretary.

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Reorienting the Canadian Economy

Policy Review and Outlook, 1986

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C.D. Howe Institute

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Foreword

Severe imbalances in the international economy arising from differing growth prospects and from some countries' serious indebtedness create uncertainty about the future. In such an environment, a small open economy such as Canada's is best managed by preparing it for the unexpected. This can best be achieved by aiming for excellence in economic performance.

During the past two years, the C.D. Howe Institute has developed a strategy for achieving such excellence. The strategy is designed to promote adjustment to rapid economic change in ways that keep inflation and unemployment consequences to a minimum. It includes making the labor market more flexible, negotiating a bilateral trade agreement with the United States, reducing the federal deficit, and reforming the tax and transfer system.

We are convinced that Canada can follow a strategy leading to excellent economic performance. The available evidence on labor-market adjustment, for example, indicates that the economy is far more able to adjust than it is given credit for. But we are also concerned, since our evaluation of policy conduct during the past year is that it has not been the best. Failure to gain secure access to export markets and to reduce the deficit sufficiently, as well as reliance on bailouts and subsidies to support declining industries, could condemn Canada to second-rate economic performance.

Still, we remain hopeful that the groundwork already laid in trade, energy, and fiscal policies can provide the basis for significant progress in 1986. External prospects promise an environment conducive to such progress. But Canada is running out of time. The chances of becoming second rate are very real — all the more so because the choices that lead to this outcome in the long term are the comfortable ones that sustain the status quo in the short term.

Ted Carmichael, Senior Policy Analyst, led the preparation of this *Policy Review and Outlook*, assisted by Bruce Ewen, Policy Analyst, and Murray Smith, Senior Policy Analyst. Barry Norris edited and Debbie Watson prepared the manuscript.

As with each *Policy Review and Outlook*, the research was discussed with and the manuscript reviewed by members of the Policy Analysis Committee. The conclusions remain the sole responsibility of the staff.

Wendy Dobson
Executive Director

1

Risks of the Status Quo

The necessity of adjusting to rapid change is now one of the inescapable facts of Canadian economic life. Governments can try to delay the inevitable by preserving the status quo. But delay simply increases the magnitude of the adjustments when they come, as come they must. Rapid technological change, increasing competition from newly industrializing countries, and uncertainty about the future stability of the international trade and financial systems all present challenges requiring adjustment.

The federal government prepared an economic agenda in late 1984 that provided a promising framework for adjustment. But loud voices defending their special interests and the status quo successfully pushed tough choices aside. By mid-1985, economic policy was in disarray.[1] With the important exceptions of changes in energy and foreign investment policies, very little progress has been made in 1985 in moving away from the status quo.

Some important groundwork has been laid, however, that could lead to significant progress in 1986. A start was made to reduce the federal budget deficit, but more action is required. An historic initiative was taken to propose comprehensive trade negotiations with the United States. This has not yet drawn an official U.S. response. In September, the Macdonald Commission *Report* provided a refreshingly clear strategic framework for future economic policy. A recommendation to seek Canadian-U.S. free trade was its centerpiece, combined with wide-ranging recommendations for changes that could improve Canada's response to the winds of foreign competition. It could halt the drift in economic policy.

The test in 1986 will be Canadians' ability to follow blueprints with action. The test applies to both the public and private sectors. Our purpose in this *Policy Review and Outlook* is to assess the changes needed to remove obstacles from the path of economic growth and to outline the dimensions of the tasks that lie ahead for both sectors.

We begin with the international backdrop to Canada's recent performance and short-term prospects. Although long-term trends in trade patterns and technology are pushing Canada to adjust, disruptions in the world economy can create a difficult and uncertain environment for ad-

[1] For an evaluation of the Mulroney government's approach to economic policy in its first 12 months, see W. Dobson, "Keeping an Eye on the Ball," *C.D. Howe Institute Commentary*, September 1985.

justment by small open economies like Canada. Yet, in 1985, the opposite has been the case. The international environment has been a favorable one — with the major exception of growing protectionist pressures in the United States.

International Economic Developments

U.S. protectionism, of course, is a symptom of more fundamental problems. World economic growth, while solid, has been slow. The U.S. slowdown in 1985 has not been offset by faster growth in the other large industrial countries. Even with a pickup in late 1985, economic activity in the industrial countries will grow only 2.8 percent in real terms compared to 5 percent in 1984. The growth of world trade has slowed down as well, to 3.5 percent in 1985 compared to 9 percent in 1984.[2]

The United States has continued to be a magnet for international capital. Its promising private-sector prospects, enormous public-sector borrowing requirements, relatively restrictive monetary policy, and improving inflation prospects have combined to push up the value of the U.S. dollar throughout much of the 1980–85 period. The strength of the dollar has battered U.S. exporters and producers competing with imports. The merchandise trade deficit, which is expected to be in the U.S.$130–150 billion range in 1985, has acted like a barometer of protectionist sentiment. U.S. industries have increased pressures on Congress and resorted to U.S. courts to stem the tide of imports.

Meanwhile, the Federal Reserve Board, increasingly concerned about weak growth in many sectors — particularly agriculture — and debt problems in many developing countries, eased monetary policy, lowered interest rates, and set the stage for a decline in the value of the dollar. In this environment, and in the absence of credible congressional action to reduce the federal budget deficit in fiscal year 1986, the September 22, 1985 meeting of the finance ministers and central bankers of the five largest industrial countries — the so-called G-5 countries — was able to achieve a dramatic, "engineered" decline in the value of the U.S. dollar. The central objective — to demonstrate to Congress that the administration is able to coordinate an international strategy to lower the dollar's value — was achieved, at least in the short term. By early November, the dollar had fallen by almost 20 percent from its March 1985 peak.[3]

Important issues arose, however, in the wake of the G-5 meeting. Exchange-market intervention cannot be expected to produce long-term shifts in a currency's value without underlying changes in economic fun-

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[2] International Monetary Fund, *World Economic Outlook* (Washington, October 1985).
[3] M. Sesit and T. Herman, "Intervention Skeptics Begin to See Dollar Running a Downhill Course," *Wall Street Journal*, October 3, 1985, p. 33.

damentals. The G-5's achievement was to change the strong-dollar psychology in foreign-exchange markets, at least temporarily. But without offsetting policy shifts in the United States — to reduce future budget deficits — and in Japan and West Germany — to speed up domestic economic growth that will attract investors and slow capital outflows to the United States — the risk is that little will have been accomplished other than replanting the seeds of inflation.

One lesson to be drawn from the G-5 meeting is that policy "engineering" cannot eliminate the need for difficult policy shifts. Congressmen may have been relieved that the drop in the dollar had stemmed the protectionist tide for the time being. But they were able to attack the budget deficit only by resorting to policy "engineering" of their own. At the root of the failure to cut the deficit is an ideological standoff between the Reagan administration and Congress. The president wants to cut spending and reduce the size of government. Congress wants some spending cuts, but also wants to raise taxes to finance existing programs. In the absence of sufficient political will to reach a compromise, the support of both the president and a bipartisan coalition in Congress has been thrown behind the idea of a "policy rule" in the form of the Gramm-Rudman-Hollings proposal. If enacted, this bill would legally bind Congress and the president to balance the budget by fiscal year 1990 through phased reductions in the deficit every year until then. In the event that the president and Congress are unable to agree on the size and composition of annual cuts, they would be bound by the legislation to impose across-the-board expenditure cuts — except in interest payments on the federal debt, existing defense contracts, and social security — of sufficient magnitude to achieve the annual target of $36 billion in cuts each year until budget balance is reached.

Since the exempted categories account for over 40 percent of total spending, deep cuts would be required in other areas of government spending. Despite this serious flaw, the degree of support for the idea suggests just how serious ideological differences have become over cutting spending and raising taxes. The budget process has broken down. Only a binding rule, which threatens everyone's interests equally, seems to show any promise.

Imbalances in the structure of U.S. growth attributable to the budget deficit and the strong U.S. dollar are shown in Table 1, which compares indicators of economic performance in Canada and the United States. U.S. growth, which had acted as an engine of the world recovery, slowed to below 2 percent by mid-1985. No single factor was responsible. The slowdown in private investment was most dramatic, but it was accompanied by a slower rise in consumer spending and continued weakness in international trade as Americans snapped up cheap foreign imports.

Table 1
Composition of Real Growth in Canada and the United States, 1982–85
(percentage change at annual rates)

	1982:Q4 to 1984:Q2		1984:Q2 to 1985:Q2	
	Canada	United States	Canada	United States
GNP	5.9%	7.1%	4.6%	1.9%
Personal consumption	4.5	5.9	4.0	3.6
Durables	14.7	14.8	7.9	6.7
Other	2.4	4.3	3.0	3.0
Gross private domestic investment	14.7	36.6	3.4	1.3
Nonresidential fixed	-6.3	16.4	5.8	8.4
Residential	8.2	30.5	10.7	2.0
Change in business inventories[a]	4.5	2.0	-0.1	-0.9
Net exports[a]	0.0	-1.6	1.0	-1.3
Exports	18.3	1.3	6.6	-1.4
Imports	18.2	7.2	3.2	4.1
Government spending	1.4	0.3	3.2	3.8

[a]Average annual increase as percentage of GNP.

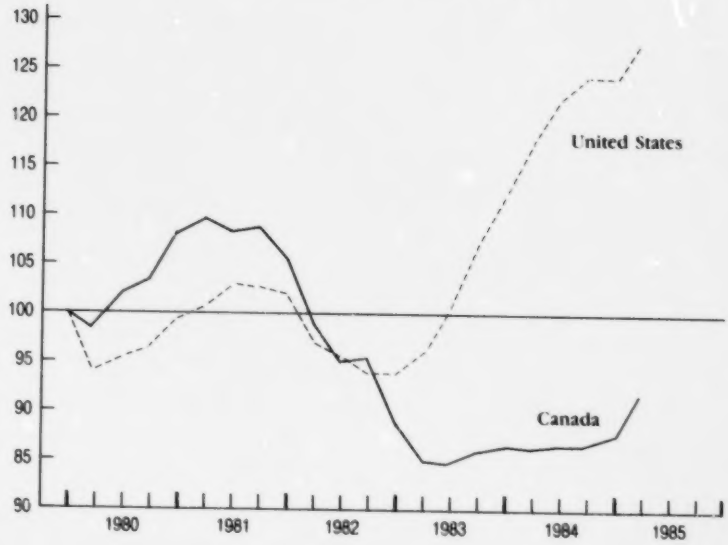
Sources: M. Foss, "The Economy at Midyear," *AEI Economist* (August 1985), p. 2; and C.D. Howe Institute.

Downward movement in inflation probably has ended in 1985, although increases in prices and costs have remained at 1984 levels. Major wage settlements in collective bargaining agreements have stabilized in the 3–4 percent range. Nonunion wages have increased at a somewhat faster pace, reflecting the stiff international competition many unionized industries face.

Canadian Economic Performance

Since mid-1984, Canada has experienced stronger overall economic growth than every other industrial country but Japan. In the early stages of the current expansion, however, Canada did less well than the United States because of weak consumer spending on nondurables and extreme weakness in private-sector investment. In particular, the recovery of private investment has been markedly slower in Canada than in the United States in the current expansion, as shown in Figure 1. There are numerous reasons for the slow recovery, including depressed commodity prices in world markets, excess capacity in several industries, and stiff compe-

Figure 1
Private Nonresidential Investment in Canada and the United States, 1980–85
(indices based on 1980:Q1 = 100)



Sources: Statistics Canada, *System of National Accounts, National Income and Expenditure Accounts*, Cat. no. 13-001, various issues; and U.S. Department of Commerce, *Business Conditions Digest*, various issues.

tition from low-wage developing countries that makes investment unprofitable in Canada. A major "made-in-Canada" reason that has been advanced is the weak equity base of Canadian companies. Canadian corporations dramatically increased their indebtedness in the early 1980s, due partly to policy-induced takeovers of foreign oil companies and partly to the need to finance unsold inventories when the recession hit. The debt-to-equity ratio of Canadian companies rose sharply in 1981–82. Although it has declined steadily since the recovery began in early 1983, the ratio remains substantially above the levels of the late 1970s.

Since mid-1984, Canadian economic growth has experienced a broadly based improvement. Consumer spending, net exports, business fixed investment, and government spending all have contributed to GNP growth.

The important question about Canada's improving performance is whether the status quo in economic policy is also increasing the economy's flexibility, which is essential to successful adjustment. Two important indicators imply that more has to be done. One is unemployment. The other is persistent industrial and regional growth differentials.

Even with stronger growth in Canada, the gap between Canadian and U.S. unemployment rates has been reduced by only one percentage point. As the economy has moved to higher capacity utilization rates, Canada's unemployment rate has declined very slowly. Figure 2 illustrates the upward shift since the mid-1960s in the curve showing the relationship between unemployment and capacity output in Canada. The curve's pattern is more similar to that observed in Europe, where unemployment has remained high as capacity utilization has increased, than in the United States, where unemployment has dropped significantly during the expansion. The Organisation for Economic Co-operation and Development, which has conducted a comparative study of this relationship in Europe, the United States, and Japan, attributes the upward shift of the curve in Europe to a combination of cost-induced scrapping of capital, introduction of labor-saving technology, and insufficient incentives for capacity-expanding and job-creating investment. Under these circumstances, even if existing capacity were fully used, unemployment would remain high in Europe.[4] The same appears to be true for Canada.

Another troubling aspect of Canada's recent performance is the continuing imbalance in growth among regions and industries. Western Canada's recovery has been slow because of the continued weakness in world commodity prices. Unemployment remains high; in British Columbia, for example, it was as high as 14.2 percent in October 1985. Despite several innovative changes in provincial government budget policies, private producers' margins continue to be squeezed. Particularly troubling were the failures of two regional banks located in Western Canada. Their insolvencies have been attributed to bad management and to concentration of loans to financially weak energy and real estate companies in Western Canada. While their failures raise questions about the risks of regional banking institutions, an unfortunate side effect of the uproar in Parliament has been an ebbing of confidence in the ability of the existing regulatory apparatus to protect the public interest. Another consequence has been to delay and redirect consideration of reforms proposed by the federal government to restructure the regulation of financial institutions.[5]

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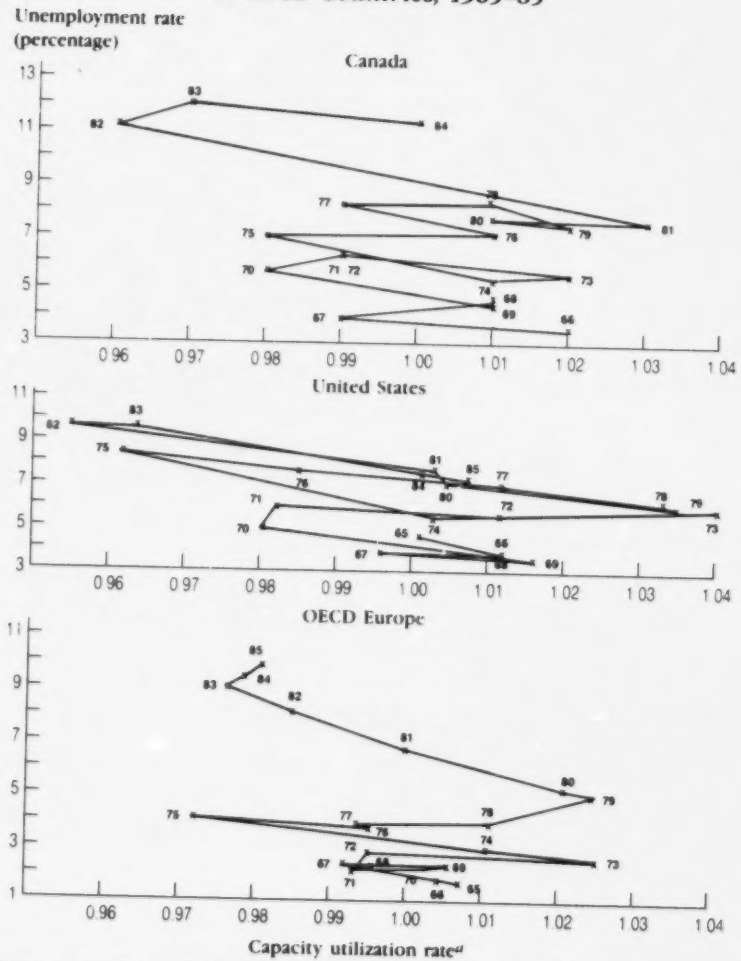
[4] Organisation for Economic Co-operation and Development, *OECD Economic Outlook* (Paris, July 1985).

[5] See Department of Finance, *The Regulation of Canadian Financial Institutions: Proposals for Discussion* (Ottawa, April 1985).

Figure 2
Unemployment Rates and Capacity Use in OECD Countries, 1965–85



[a]Ratio of actual real GDP to phased trend.

Sources: Data for Canadian unemployment rates are from Statistics Canada, *The Labour Force*, Cat. no. 71-001, various issues. Other data were obtained from the Organisation for Economic Co-operation and Development.

Reorienting Canada's Policy Framework

The slow decline in Canada's unemployment rate and continued regional and industrial imbalance in growth are troubling because they are symptoms of deeper problems of adjustment to rapid change. Canada's recently improved performance relative to the United States is welcome news, but it should not be taken as a sign that "all is well" after all. To sustain this more balanced growth in 1986 major changes are still required in the framework and conduct of Canadian economic policy. Continuing as we are contains too many risks.

The Macdonald Commission Report

The necessity for change is clearly outlined by the Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission) in its final *Report*. This document adopts three important themes:

- Canada is a small open economy in an increasingly turbulent and uncertain international environment;
- the ability to adjust to rapid economic change should become a central policy goal; and,
- greater market orientation in economic policy will facilitate, rather than obstruct, adjustment.

The Commission bases these themes on choices between a closed and an open economy framework; between protection and adjustment; between intervention by government and a more "hands-off" approach.[6] Taken together, they represent a fundamental departure from long-established tradition — a tradition often based on distrust of markets, dependence on the public sector, and a tendency to follow protectionist trade and industrial policies.

For the most part, the Commission's economic policy recommendations would improve the economy's ability to adjust — to reallocate factors of production in response to changing economic conditions. Accepting the need for continuous adjustment to maintain competitiveness and ensure growth, however, implies a changed policy framework. If long-term growth in incomes and employment is to be the central goal, then shorter-term goals of stabilization policy — such as price stability

[6] For a critique and interpretation of the *Report*'s economic policy framework and recommendations, see E.A. Carmichael, W. Dobson, R.G. Lipsey, "The Macdonald Report: Signpost or Shopping Basket?" *Canadian Public Policy* (forthcoming).

and full employment — must be evaluated according to their impact on this central goal. Tradeoffs must then be made, not just among short-term goals, but between long- and short-term goals as well.

Within this framework, the Commission's recommendations, if implemented as a package, would imply some profound changes for the Canadian economy. Negotiations on a free-trade area with the United States would be accompanied by a "framework" industrial policy aimed at working in tandem with markets, limiting government intervention, and encouraging private-sector investment; by an approach to regional economic development that alters the federal government's role to one that aims to reduce existing gaps in productivity across regions; and by social policy that strengthens the safety net — making it less a trap and more a trampoline — by reducing disincentives to work, move, and retrain created by the patchwork of existing programs. The reduction of unemployment ranks at the top of the Commission's list of objectives to be achieved by more flexible adjustment. But it is so concerned about this goal that it complements its adjustment-promoting recommendations with fiscal and monetary policy proposals that are perhaps unduly stimulative and, if implemented, could repeat policy errors committed in the early 1970s that contributed to Canada's great inflation.

Even so, the *Report* stands up to scrutiny as a Grand Plan — a signpost to a reoriented policy framework in Canada. The question now is, Will it be implemented? Some proposals, such as reform of unemployment insurance and the introduction of a Transitional Adjustment Assistance Program, look like they might be adopted. Action is already under way on trade policy, although the outcome is far from clear. Since the election of a new federal government in September 1984, Canadian economic policy has begun to move in the direction of an adjustment- and market-oriented framework. The answer probably is that the *Report* provides a framework against which ongoing policy developments will be evaluated for some time to come. We now turn to one such evaluation.

Structural Policy Reforms in 1985

Energy Policy

The Western Accord of March 1985 was a significant step toward a more market-oriented policy framework for the energy industry. By decontrolling the price of crude oil, the Accord wiped out a complex system of administered pricing and introduced one that, instead, relies on flexible prices as the best guide for investment decisions. It dismantled the inflexible structure of energy taxation in a way that has improved confidence in the industry and resolved the revenue-sharing dispute of the last ten years between the western provinces and the federal government. The

Accord also set in motion a process in which the federal government and the producing provinces have pledged to work toward a more market-responsive pricing system for natural gas in consultation with the consuming provinces and the natural gas industry. The first step in this process was taken in October 1985, when a more flexible system for pricing natural gas in domestic and export markets was adopted.

Some critics have argued that the energy deal was a bad one for Ottawa because it gave up a lucrative revenue base. The deal will cost the federal government over $2 billion annually in foregone revenues by the end of the decade, aggravating the deficit problem. But there are two important offsetting considerations. First, the objective of both levels of government was to move toward a more market-oriented energy policy to revitalize confidence and activity in the industry. The energy sector is a test case in which there is considerable potential for improvement in the investment climate through reduced government intervention. If the petroleum industry responds by reinvesting a higher proportion of its increased cash flow, this will give a significant boost to the economy of Western Canada, which has lagged behind the national economic recovery.

Second, the federal government has made it clear that if industry reinvestment does not increase from the low levels of 1984, it will consider other options. One would be to impose a new tax on industry profits that would act as a delivery vehicle for new, tax-based exploration incentives. Such a change would place smaller, Canadian-owned energy companies that produce from new, high-cost wells on a more even footing with the large, integrated petroleum companies that produce from old, low-cost wells.[7]

Investment Canada

The replacement of the Foreign Investment Review Agency (FIRA) by Investment Canada was intended to send a signal to foreign and domestic investors alike that Canada was adopting a more welcoming attitude toward private investment. Unlike FIRA's defensive role of screening foreign investment to ensure "benefit to Canada", Investment Canada has been given a positive mandate to promote Canada as a place to invest.

The federal government's primary concern was with FIRA's negative image at home and abroad. Among the substantive legal changes that were adopted was a useful distinction between new investment and takeovers of existing assets. Most new investment tends to create jobs for Canadians; exempting new investment from review — with the exception of that

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[7]See E.A. Carmichael and C.M. Herrera, "Toward More Flexible Energy Policy," in E.A. Carmichael and C.M. Herrera, eds., *Canada's Energy Policy: 1985 and Beyond* (Toronto: C.D. Howe Institute, 1984), pp. 9–11.

in culturally sensitive industries — makes sense. It also makes sense to introduce a threshold level for review of foreign takeovers.

But Investment Canada is likely to continue to act as a significant obstacle to foreign investment in Canada because the threshold level of $5 million in assets was set too low. No automatic provision for increasing it over time was incorporated. This low threshold level will continue to impose a significant regulatory burden on small businesses. Continued review of relatively small transactions will likely discourage small firms from expanding above the threshold level so that they can retain the option of selling their business to either foreign or domestic investors.

On balance, the government's changes to FIRA were in the right direction but their positive effect on private activity in Canada is not likely to be large. While Investment Canada's image is better than that of FIRA, the government did not match this change by equally bold moves to limit foreign investment review only to large-scale or culturally sensitive takeovers.

Macroeconomic Policy and the Federal Deficit

The federal budget deficit continues to pose obstacles to stronger private-sector growth in the medium term. In spite of expenditure cuts and tax increases totaling $4.4 billion in fiscal year 1985–86 and $8.4 billion in fiscal year 1986–87, the actual budget deficit during the next two years is expected to remain in the range of $33–34 billion.[8] Each year, these budget deficits will add to the accumulated federal debt. In mid-1985, the federal public debt passed the $200 billion mark — about 45 percent of GNP. Three years earlier, the public debt was $100 billion — about 30 percent of GNP. The debt is now projected to double again to $400 billion by the end of the decade. The expenditure cuts and tax increases adopted so far will only be sufficient to keep the annual deficit in the $25–35 billion range until the end of the decade, and they will fail to prevent debt from accumulating at a faster rate than the economy grows.[9] Even under optimistic economic assumptions, the growth of federal public debt will outstrip the growth of the economy by a wide margin and reach 60 percent of GNP by the end of fiscal year 1990–91.

The main reasons for concern about this rapid projected increase in federal debt are that it makes Canada vulnerable to adverse interest-rate developments and it is likely to restrain private-sector growth. Such restraint is likely to operate in three ways. First, as the expansion continues, large government-borrowing requirements are absorbing more than half of the net savings generated by the private sector. These savings are chan-

[8]Department of Finance, *The Fiscal Plan* (Ottawa, May 1985), pp. 5, 24.
[9]Dobson, *Keeping an Eye on the Ball*, p. 6.

neled largely into consumption activities financed by the public sector instead of into private investment.[10] Second, as federal debt continues to accumulate, interest payments on the debt will consume a rising share of federal revenues. To contain this tendency, the federal government has already moved to raise personal and corporate tax rates, thereby weakening private-sector activity. Third, the persistence of large budget deficits constrains the Bank of Canada — which is concerned about avoiding any acceleration of inflation — from allowing interest rates and credit conditions to ease as much as they otherwise could. A change in the "policy mix" is required — to a less expansionary fiscal policy and a more expansionary monetary policy — to reduce nominal and real interest rates and encourage private investment.[11] A start in this direction has been made in 1985 but more needs to be done in 1986, as we indicate in the final chapter.

Trade Policy and Tax Reform

Trade and tax policies are two other areas that affect Canada's ability to adjust and grow. In 1985, forward movement has occurred in both. In September 1985, the federal government made an historic decision to propose comprehensive trade talks with the United States with the objective of reducing trade barriers between the two countries. Growing protectionist pressures in the U.S. Congress pose a significant threat to Canada and an obstacle to further trade liberalization. The United States' increasing use of contingent-protection measures — such as countervailing duties, and unfair-trade and emergency safeguard measures — greatly increases the risk for firms planning to serve the entire North American market from Canada. If Canada is to escape the worst consequences of U.S. protectionism, it will have to be prepared to give up some of its own protectionist practices.

Momentum for tax reform is building in Canada, at both the federal and provincial government levels, for several reasons. First, there is growing recognition that tax-rate increases to reduce the federal deficit are worsening distortions in a system that already biases decisions. Second, a tax-reform debate has been under way in the United States for several years. President Reagan unveiled his tax-reform blueprint in May, and by

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[10] For a discussion of the relatively small proportion of federal spending that goes to public capital spending, see D.A.L. Auld, ***Budget Reform: Should There Be a Capital Budget for the Public Sector?***, Policy Commentary no. 6 (Toronto: C.D. Howe Institute, 1985).

[11] See C.D. Howe Institute, ***Beyond Recovery: Adjusting to the Future***, Policy Review and Outlook, 1984 (Toronto, 1984), pp. 64–67; and Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], ***Report***, vol. 2 (Ottawa: Supply and Services Canada, 1985), pp. 319–320.

late 1985, congressional leaders were in the process of drafting their own reform bill. The key features of U.S. tax-reform proposals include substantial reductions in marginal tax rates for individuals and corporations, and the reduction or elimination of a broad range of tax exemptions, deductions, and credits. These changes could create major differences between the Canadian and U.S. tax systems and the incentives for investment and risk-taking in the two countries.

What About the Private Sector?

Much remains to be done to reorient economic policy to facilitate, rather than obstruct, adjustment in Canada. But it is the private sector that must provide much of the initiative for, and bear much of the burden of, adjustment. The success of a market-oriented growth strategy depends on private-sector response -- by large and small businesses and by unionized and nonunionized employees.

Some critics question the private sector's desire and capacity to take up slack that might be created by winding down public-sector activity. Others point to doubts about the capacity of Canada's employers and employees to succeed in highly competitive world markets without significant government intervention. Does the private sector exhibit sufficient dynamism? Does it possess the necessary management skills and entrepreneurial outlook? Is is innovative enough to compete effectively with Americans, Japanese, Europeans, and with aggressive newly industrializing countries? Does it have access to sufficient financial resources? Are labor-management relations sufficiently cooperative to allow the private sector to adapt to competitive pressures and new technologies?

The limited evidence available to answer these questions is mixed. An annual survey of 28 countries conducted by the European Management Forum has ranked Canada between sixth and eleventh in overall competitiveness in the last three years.[12] Canada places well in some categories, including natural-resource endowment, human resources, and financial and market dynamism. However, it ranks in the bottom half of countries surveyed in other important categories, including industrial efficacy, sociopolitical consensus, outward and innovative forward orientation, and state interference in the economy. It also ranks poorly in detailed comparisons of productivity. Canadian products compare unfavorably in quality, design, styling, safety, on-time delivery, and after-sales service. Canadian employees rank poorly in their willingness to work efficiently and to

[12] See European Management Forum, *Report on International Industrial Competitiveness* (Geneva: EMF Foundation, 1984); and Macdonald Commission, *Report*, vol 2, pp. 108–129.

accept labor-saving devices; Canadian managers rank poorly in entrepreneurship.

Such subjective surveys are useful indicators of how managers in other countries view Canadians. What is less clear is why Canada ranks so poorly in many key categories. One reason could be that Canadians lack the skills and experience needed to excel in world markets. The Canadian private sector has been shielded systematically from competition, both domestic and foreign, by government industrial policies. Some of these deficiencies will be corrected as the economic policy framework shifts further toward the adjustment- and market-oriented approach that began in 1985. But faster movement is needed, both in policy and by the private sector.

Outline of the Policy Review and Outlook

Chapter 2 examines the dynamics of adjustment and the job-generation process in Canada. While the dynamic process of business startups and failures has already changed the structure of the Canadian economy, much more progress is required to increase competitiveness and the ability to innovate.

Chapters 3 and 4 assess two major policy issues Canadians face in 1986. The first is Canada's bilateral trade initiative with the United States, which is examined in Chapter 3. The chapter identifies key negotiating issues, as well as some of the tradeoffs that Canadians will have to make in return for increased and more secure access to the large U.S. market.

The second major policy issue is a restructuring of the tax and transfer system to reward private initiative, the prospects of which are assessed in Chapter 4. The federal government is considering several reforms that we think could end up exacerbating flaws in the existing system. This contrasts sharply with two strategic initiatives — one from the Quebec government and one from the Macdonald Commission — that are now on the table. Both have proposed comprehensive reforms to remove serious distortions to work incentives, and savings and investment decisions, and to reduce the complexity and improve the fairness of the system.

Chapter 5 outlines the policy agenda for 1986. Trade policy will top the agenda. More action on deficit reduction is also required. Reform of the tax and transfer system will facilitate success of those two initiatives. Having let one year pass with little change in the status quo, policymakers face tasks in 1986 of even greater urgency. If this challenge is not met, Canadians' confidence in their economy could begin to erode.

2

Sharpening Canadians' Economic Self-Image

Contrasting with the realization of rapid, worldwide economic change is an image many Canadians hold that their economy changes only slowly. They tend to think of the economy as resource-based, with manufacturing and services sectors to complement it. Canadians' image of industrial stability and evolutionary change contributes to an unfortunate attitude toward change. This attitude is based on the view that dynamic changes in technology and world markets are disruptive and harmful to Canada — that they lead to unacceptable dislocations, to higher unemployment and, eventually, to reduced living standards. This attitude also leads companies — and entire industries — to plead for subsidies or protection from imports to maintain jobs threatened by changing market conditions. It also causes resistance to changes in economic policy that promote "industrial adjustment" — a term which really means allowing labor and capital resources to move out of declining industries and allowing market forces to determine how these resources will be reemployed. This kind of resistance can be seen in the objections some Canadians have to negotiating a trade agreement with the United States. They fear that some industries will experience large-scale job losses and that people who become unemployed will be unable to find work elsewhere in the economy.

The image of the Canadian economy as inflexible and unable to thrive in an era of rapid change and increasing competitiveness in the world economy persists largely because of the continuing lack of evidence to the contrary. This chapter presents new evidence that, in fact, dynamic change is the norm in Canada, that a principal agent of change and job generation is the small-firm sector of the economy, that adjustment occurs primarily through changes in the rate of business startups across industries, and that this ongoing process is reshaping the Canadian economy.

The Dynamics of Adjustment and Job Generation

Contrary to the image of gradual evolutionary change, the Canadian economy is in a constant, dynamic state of flux. In the labor market, for example, there is continual turnover as workers change jobs, lose jobs and search for new ones, or leave the labor force altogether, while new

people enter.[1] In 1984, of the people who were employed at some time during the year, just 62 percent were employed for the whole year.[2] The other 38 percent — over 5 million people — changed their employment status at least once during the year. Even among the 62 percent who were employed all year, a considerable proportion would have changed jobs either within an organization or by moving from one organization to another without spending any time unemployed. A conservative estimate, therefore, is that nearly one-half of all Canadians who worked in 1984 changed jobs at least once during the year. Similarly, there is a constant turnover of private businesses as new firms are launched while existing firms fail, as is examined in detail later in this chapter.

This transitional process has accelerated in the 1980s under the twin pressures of recession and increased international competition. If the turnover rate of businesses and jobs is high, the structure of the economy can be transformed quite quickly as some industries and occupations flourish while others decline. Workers and businesses carry out this restructuring as they constantly seek new opportunities for employment and profit. In which sectors of the economy these opportunities arise depends, in part, on changing tastes, technology, and international market forces. It also depends on how governments intervene with their trade, industrial, tax, and regulatory policies to override market forces. If these policies block adjustment by protecting or favoring certain sectors, the full benefits of a dynamic private sector will not be achieved. Turnover of businesses and jobs will occur, but capital and labor might not be reemployed in their most productive uses.

Table 2 shows changes in industry and occupational employment from the economic peak of mid-1981 until mid-1985. It contains two striking indications that the jobs created in the current expansion are not the same as those lost in the 1981–82 recession. The first is the dramatic swing in employment away from goods-producing and toward services-producing industries. There were almost 300,000 fewer jobs in the goods sector in mid-1985 than four years earlier, while there were over 500,000 more jobs in the services sector. Three out of every four net new jobs created since the trough of the recession in December 1982 have been in the services sector. This is in spite of a relatively strong cyclical rebound in goods

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[1] For a discussion of the theory and evidence on labor-market dynamics, see E.A. Carmichael and W. Dobson, *Achieving a Realistic Recovery*, Policy Review and Outlook, 1983 (Toronto: C.D. Howe Institute, 1983), pp. 32–36; K. Clark and L. Summers, "Labor Market Dynamics and Unemployment: A Reconsideration," *Brookings Papers on Economic Activity* 1 (1979): 13–60; and A. Hasan and P. de Broucker, "Duration and Concentration of Unemployment," *Canadian Journal of Economics* 15 (November 1982): 735–756.

[2] R. Veevers, "Results from the Annual Work Patterns Survey: 1983 and 1984," *The Labour Force* (Statistics Canada, Cat. no. 71-001), July 1985, p. 109.

Table 2
Changes in Employment by Industry and Occupation, 1981–85
(thousands of jobs)

Industry[a]	Employment August 1981	Change in employment August 1981–Dec. 1982	Dec. 1982–June 1985	August 1981–June 1985
Goods-producing industries	*3,615*	*-493*	*202*	*-291*
Agriculture	493	-31	22	-9
Other primary industries	334	-70	18	-52
Manufacturing	2,132	-305	147	-158
Service-producing industries	*7,444*	*-61*	*573*	*512*
Construction	656	-87	15	-72
Transportation	914	-24	-16	-40
Trade	1,902	-84	191	107
Finance	600	-26	46	20
Services[b]	3,248	77	334	411
Public administration	780	-4	18	14
Total	*11,059*	*-554*	*775*	*221*
Occupation[a]	**June 1981**	**June 1981–June 1983**	**June 1983–June 1985**	**June 1981–June 1985**
Managerial, professional	2,665	72	462	534
Clerical	2,000	-95	33	-62
Sales	1,106	67	-107	-40
Service	1,546	52	13	65
Primary occupations	760	-15	-19	-34
Processing	1,739	-252	104	-148
Construction	720	-100	29	-71
Transportation	423	-24	44	20
Materials handling, crafts	432	-26	-5	-31
Total	*11,391*	*-321*	*554*	*233*

[a]Industry data are seasonally adjusted; occupational data are not seasonally adjusted.

[b]Community, business, and personal services.

Sources: Statistics Canada, *Historical Labour Force Statistics: Actual Data, Seasonal Factors, Seasonally Adjusted Data, 1983*, Cat. no. 71-201 (Ottawa, 1984), pp. 129–136; and idem, *The Labour Force*, Cat. no. 71-001, July 1985.

production and the creation of many new jobs in some goods-producing industries that are internationally competitive.

Table 2 also indicates that Canadians increasingly are becoming skilled professionals, rather than hewers of wood and drawers of water. The economy is relying less on unskilled manpower and more on high technolo-

gy, capital equipment, and skilled people to extract and process natural resources and to manufacture finished goods. The increase in employment in managerial and professional occupations over the past four years exceeds half a million, while employment in all other occupations has declined by 300,000, with half of the decline concentrated in processing jobs.

How is this transformation in the structure of Canadian employment taking place? Who are the new employers and in what specific sectors of the economy are they found? How big are they and where are they located?

A new study of the job-creation process in Canada, sponsored by the Department of Regional Industrial Expansion and conducted by David Birch of the Massachusetts Institute of Technology, provides some answers to these questions.[3] Birch examines the employment history of over half a million Canadian companies listed in a data base maintained by Dun and Bradstreet Canada Ltd. The companies on the Dun's Market Identifier list represent all industries in the private sector and account for about 60 percent of all private-sector employment as estimated by Statistics Canada.

Birch reasons that for any industry or region, the change in total employment over a period of time can occur in four distinct ways. On the plus side, jobs are created whenever a new business starts up or an existing firm expands. On the negative side, jobs are lost whenever a company ceases operations or lays off workers. Birch refers to these four categories as births, expansions, deaths, and contractions.

Tables A1 and A2 in the Appendix show the components of net job change by industry and by region over the 1974–82 period.[4] From this evidence, five important observations can be drawn about the process of job creation and economic transition.

First, there was an extremely wide divergence in the rate of net job creation in different industries and regions of the country during those years. For example, employment in business services grew at a rate of 10.1 percent per year, while employment in manufacturing grew by only 0.9 percent. Such a wide divergence indicates that a substantial shift in the structure of employment took place.

Second, apart from such quasi-public services as health, education, and social services, there was a remarkable constancy in the rate of job losses

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[3] See Department of Regional Industrial Expansion, *A Study of Job Creation in Canada, 1974–82* (Ottawa, 1985).

[4] It should be noted at the outset that the starting and end points of the period of analysis represented quite different stages of the business cycle. For this reason, employment changes might vary somewhat if another time period was examined.

across industries and regions. Over the eight-year period, virtually all industries experienced job losses through firm closures and contractions in the range of 38 to 48 percent of employment from the base year of 1974. The range across provinces was even narrower.

Third, the contribution of business startups (births) was the single most important factor determining the rate of net employment creation across industries and provinces. The industries with the greatest amount of start-up activity are those that are reshaping the structure of employment in Canada. Seventy percent of the increased employment in enterprises reporting gains was the result of startups; only 30 percent came from the expansion of existing enterprises.

The evidence also suggests that the industries and regions generating the greatest net employment increases were those that had relatively high rates of job losses. The most dynamic areas and industries appear to have been those that attracted business startups, risk-taking, and innovation, and that tolerated relatively high failure rates. In industries and regions where failures were low, net job creation seems to have suffered from a lack of new enterprise.

Table A3 further illustrates this point: in manufacturing, job creation varied widely across provinces. The provinces with the greatest net employment gains over the 1974–82 period, Newfoundland and Alberta, were also those in which business startups contributed most to job creation ***and*** in which there were relatively high job losses due to business failures. Ontario and Quebec, the dominant manufacturing provinces, were relatively less successful in attracting startups and also lost a smaller proportion of jobs through enterprise failures.

Fourth, the leading job-generating industries were concentrated in the services sector of the economy. Business, social, and professional services were the most dynamic industries in terms of jobs created by business startups and they provided the greatest job growth. The amusement, recreation, and accommodation industries also recorded substantial job growth, reflecting the increased demand for leisure activities. The increasing scale and sophistication of Canada's financial system also produced relatively strong employment growth in the finance, insurance, and real estate industries. Goods-producing industries such as manufacturing, construction, and forestry provided low rates of job growth, although some industries performed well. Within manufacturing, for example, industries such as transportation equipment, primary metals, machinery, paper, wood products, and chemicals recorded good levels of net job creation and healthy levels of business startups.

Fifth, small enterprises with less than 20 employees made the greatest contribution to overall job growth between 1974 and 1982. Fifty-five percent of the net increase in total employment occurred in these business-

Table 3
Net Employment Change by Enterprise Size, 1974–82

Enterprise size (number of employees)	Net employment change	
	thousands of jobs	percent
0-19	613 087	54 7%
20-99	102 245	9 1
100-499	-35 445	-3 2
500+	441 705	39 4
All enterprises	*1 121 592*	*100 0*

Source: Based on data from Department of Regional Industrial Expansion, *A Study of Job Creation in Canada, 1974-82* (Ottawa, 1985).

es, as shown in Table 3.[5] Just less than two-thirds of the total gain in employment took place in enterprises with less than 100 employees. In an earlier study of job generation in the United States, Birch found that enterprises with fewer than 100 employees were responsible for 80 percent of net employment growth between 1969 and 1976.[6] Large firms with more than 500 employees also made a significant contribution, accounting for just under 40 percent of net job creation in Canada. Mid-sized enterprises with 100–500 employees actually experienced a decline in employment over the period — a surprising result since such mid-sized firms have been important job generators in the United States.

The image of the economy, then, that emerges from this evidence is one of considerable flexibility and dynamism in job flows in Canadian enterprises, and it is on this more appropriate image that economic policy should be based. The relative importance of small firms and the serv-

[5]Estimates of the contribution of firms of different sizes to net job creation should be treated with some caution. They will vary depending on the data base used and the time period covered. The Dun's Market Identifier data base used in the DRIE study, for example, is known to under-report the number of company births. In many cases, firms enter the data base only when a credit check is done on them. Some short-lived firms, therefore, are never captured. The time period chosen can also affect the estimates — existing evidence indicates that small firms account for a greater proportion of net job generation in recession years. Preliminary estimates using the Dun's Market Identifier data base for the period 1976–84, which capture the impact of the recession, indicate that companies with less than 20 employees contributed approximately 85 percent of the net new jobs over the period. Work being carried out by Statistics Canada, based on payroll data covering the period from 1978–83, also indicates a higher contribution of net new jobs from small companies than that reported in Table 3. Nevertheless, one general conclusion is common to all studies: small enterprises contribute a disproportionate share of net new jobs.

[6]G.D. Birch, "Who Creates Jobs?" *The Public Interest* 65 (Fall 1981): 8.

ices sector in net job creation does not mean, however, that large firms or the goods-producing sector lack dynamism or the ability to adjust to change. On the contrary, to remain competitive in domestic and international markets they have had to restructure their operations and increase their productivity. Nor would it be correct to conclude, based on this evidence, that public policy should subsidize small firms or the services sector in order to enhance their job-creating potential. Instead, the evidence should be used to challenge the image Canadians have that their economy is inflexible and slow to adjust.

In a previous *Policy Review and Outlook*, the Institute argued that inflexibility of wages and prices in the face of an anti-inflationary monetary policy was one reason for the severity of the last recession, which saw the unemployment rate rise to almost 13 percent in 1982.[7] Because wage flexibility was initially limited, firms had little alternative but to cut employment in the economic downturn. The evidence presented here suggests that while Canadian wage flexibility may have been less than desired, the dynamism of the job-generation process through small-enterprise startups has contributed greatly to reemployment and economic restructuring. The evidence further suggests that removing obstacles to this inherent dynamism should be a high priority of economic policy. This means relying less on traditional policy instruments that permanently shield firms or industries from adjustment — such as restrictions on imports, bailouts to save ailing firms, and subsidies that prop up marginal industries. It also suggests, as have other studies, that the process of adjustment to changes in trade or tax policies will take place not through large increases in business failures, but through reduced business startups in previously favored industries and through increased births and expansions in industries that have not enjoyed protection or tax preferences in the past.

Some Recent Examples of Job Loss and Replacement

The statistical evidence indicates that the deep recession of 1981–82, the uneven recovery that has followed, and the accelerating structural reorientation of the economy have caused substantial job losses in some sectors of the economy and rapid job growth in others. A review of some specific examples of where jobs have been lost and how firms and individuals have had to adjust further illustrates the dynamism and flexibility of the Canadian economy.

Job losses during the past decade have been concentrated in large firms in the natural resources, manufacturing, and construction sectors of the economy. Within manufacturing, labor-intensive industries have been

[7]Carmichael and Dobson, *Achieving a Realistic Recovery*, pp. 14–18.

hardest hit by plant closures and employment cuts. Six industries in particular — rubber, leather, textiles, knitting, clothing, and furniture — have been especially vulnerable. Almost half of the jobs that existed in this group of industries in 1974 were lost because of plant shutdowns or contractions by 1982. In spite of competitive pressures, however, about eight of every ten jobs lost in these industries were replaced by enterprise start-ups or expansions.[8] Over the same period, large firms in these industries generated a net employment loss of 20 percent, while small firms generated a net gain of 17 percent.

Employment levels of 50 of Canada's largest private-sector employers, listed in an annual survey by *Canadian Business* magazine, provide another indication of the scale of job losses in large corporations. These levels fell by 101,000 — about 10 percent — between 1981 and 1984. Employment changes in selected large companies, shown in Table 4, exhibit wide divergences. Some of the largest job losses were recorded by companies in heavy industries such as metals, petroleum, forest products, and heavy equipment. Large gains were made by some large companies in the services sector and in communications equipment. On balance, however, a considerable number of jobs have been lost in large companies in recent years.

This does not mean that large companies will not make a positive contribution to employment growth in the future. In many cases, the rationalization that took place in the early 1980s has been sufficient to restore these companies' cost competitiveness and profitability. The example of Canada's iron ore industry is instructive.[9]

Following the second oil shock in 1979–80, world steel production went into a steep decline. Demand for steel and iron ore dropped because of the recession and an accelerating substitution of lighter, more energy-efficient metals, and occurred at a time when new iron ore mines were coming on stream in Brazil and Australia and currency devaluations were making iron from Scandinavia and Latin America more competitive. Demand for Canadian iron ore dropped to 33 million tons in 1983 from 50 million tons in 1980. Firms in Canada had no choice but to take drastic rationalization measures to survive. The result was major plant shutdowns and large job losses. In Gagnon, Quebec, the entire population of 6,000 left when the town's mine and concentrator were shut down permanently. Other towns, such as Schefferville, Port-Cartier, and Septlles, also lost much of their populations.

While this rationalization cut Canadian iron ore capacity by almost one-

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[8] Department of Regional Industrial Expansion, *A Study of Job Creation in Canada.*

[9] See R. Gibbens, "Quebec's iron ore industry has more confident stance," *Globe and Mail* (Toronto), July 31, 1985, p. B5; and R. Anderson, "Manufacturers are adjusting to competitive global market," *Globe and Mail* (Toronto), August 2, 1985, p. B2.

Table 4
Employment in Selected Canadian Companies, 1981 and 1984

Company	Persons employed			
	1981	1984	Change	% Change
Massey-Ferguson	39,789	20,262	-19,527	-49.1%
Inco	31,678	22,239	- 9,439	-29.8
Canadian General Electric	19,987	12,300	- 7,687	-38.5
MacMillan Bloedel	22,049	14,994	- 7,055	-32.0
Stelco	26,263	20,612	- 5,651	-21.5
Abitibi-Price	20,000	14,793	- 5,207	-26.0
Dome Petroleum	9,500	6,000	- 3,500	-36.8
Loblaw Companies	36,000	33,000	- 3,000	- 8.3
F.W. Woolworth	29,000	26,000	- 3,000	-10.3
Gulf Canada	11,367	8,982	- 2,385	-21.0
IBM Canada	11,657	11,725	68	0.6
General Motors of Canada	43,076	45,391	2,315	5.4
Alcan Aluminium	66,100	70,000	3,900	5.9
Steinberg	26,000	31,000	5,000	19.2
McDonald's Restaurants	40,000	50,000	10,000	25.0
Northern Telecom	35,444	47,000	11,556	32.6

Source: "Canada's Top 500 Companies," *Canadian Business*, July 1982, July 1985.

third, the remaining plants have become profitable and have increased their international competitiveness. The introduction of computer controls has increased efficiency and improved the quality of the product. If the industry continues to improve its technology, its close technical cooperation with customers, and its relations with employees and unions, industry analysts believe it can retain and eventually improve its world market share.

The example of the iron ore industry illustrates the situation in which many large firms in the natural resources and manufacturing industries find themselves. The combination of the recession and stiffer competition from developing countries has forced them to concentrate on improving productivity and cutting costs. In resources industries where Canada traditionally has had a comparative advantage, it is challenged increasingly by new, low-cost producers in developing countries. Employment is now stabilizing and could pick up gradually if economic expansion continues and resources prices move up. In other industries, such as the labor-intensive group of manufacturing industries mentioned earlier, where Canada does not enjoy a comparative advantage, net employment gains in the future are unlikely.

Jobs lost in large firms are less a matter of concern if they are being

replaced elsewhere in the economy. The evidence indicates that small firms have been generating large numbers of new jobs, particularly in the services sector of the economy, and that these have been more than enough to offset losses in large firms. Total employment growth has not been sufficient, however, to absorb all new labor-force entrants and to reduce the number of unemployed. Consequently, unemployment remains significantly higher than in 1981, prior to the recession. In part, the causes of continuing high unemployment reflect demographic developments of recent years, as well as macroeconomic and international market conditions. But the evidence also suggests that employers and employees in the private sector face a significant challenge to make the adjustments necessary to succeed in world markets.

Private-Sector Strategies for Adjustment and Growth

As employment opportunities in large firms have diminished and as rapidly rising public debt has forced governments to curtail their hiring, the small-enterprise sector of the economy has come to be seen as an increasingly important agent of economic adjustment and employment growth. In some regions of the country where unemployment has remained high well into the recovery, community groups and business organizations have begun to develop their own strategies for stimulating new enterprises and creating jobs.

Some of the best-known examples of community economic development initiatives are to be found in British Columbia, where many towns rely heavily on the mining or forest-products industries for their livelihood. The still-depressed state of world markets has meant that many of the jobs lost during the recession have not been restored. The best strategy for improving these industries' future employment prospects is to increase their competitiveness through the adoption of new, cost-effective technologies, more flexible compensation systems, and an internationally competitive tax structure. While there is some evidence that a slow turnaround in these industries is beginning, future employment growth is likely to be modest.

As this restructuring process continues, groups like the Social Planning and Review Council of British Columbia actively promote community economic development activities in that province.[10] In general, such activities have arisen in towns with very high unemployment rates — above 20 percent — and have grown out of actions undertaken by citizens groups and local economic development agencies.

The Canadian Chamber of Commerce also has a job-creation strategy

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[10] C.T. Strandberg, *Community Economic Development in British Columbia* (Vancouver: Social Planning and Review Council of British Columbia, 1985).

with its Youth Employment Opportunity Initiative. This community-based program is organized by local Chambers or Boards of Trade in conjunction with representatives of local government, labor, business, community service, and youth groups. The program is designed to match young people with jobs in existing firms, stimulate new ventures by young people, provide training, and communicate with local employers about government programs to assist job creation. Forty communities across Canada now participate in the project.

What such programs have in common is a spirit of private initiative and self-reliance. Although government funding may be employed to get projects off the ground, the ultimate objective is to generate profitable, self-sustaining enterprises.

Large firms could do more to promote this type of private initiative in Canada. In particular, the participation of large firms in initiating community economic development programs in towns where they have laid off large numbers of workers is limited. Large firms in some other countries, including the United Kingdom, France, the Benelux countries, and the United States, appear to be considerably more active in this area than are Canadian firms.[11]

British Steel Corporation (BSC) is perhaps the best-known example.[12] Since 1977, BSC has reduced its workforce by 150,000. In 1975, in what was later acknowledged to be primarily a public-relations effort, the company formed BSC Industry Ltd. to provide other firms with incentives to enter distressed steel communities. As massive layoffs continued, BSC Industry evolved into an investment and venture-capital business and in 1984 became self-funding. In the process, the company has invested in 2,000 projects and created over 30,000 jobs, with future expansion forecast to reach over 50,000 jobs. To assist startups, the company has converted obsolete iron and steel works into small workspaces suitable for new, small enterprises. These low-cost workspaces provide an environment for risk-taking and innovation, and yield a return to BSC on defunct steelmaking facilities.

This example illustrates how adjustment might be facilitated in communities that have large numbers of skilled workers who have been laid off. The availability of these skilled workers represents an opportunity for venture capitalists and for entrepreneurial initiatives that Canadian firms have ignored. There is a policy lesson to be learned as well. One of the resources available to the laid-off British worker has been a tax-free severance payment. Often, these payments have been a key factor

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[11] Organisation for Economic Co-operation and Development, "Large Company Involvement in Local Economic Initiatives" (Paris, 1985, Mimeographed).

[12] J. Dunbar, "Job Creation: The Experience of the British Steel Corporation" (April 1985, Mimeographed).

in providing skilled workers with the necessary capital to begin a new venture of their own.

Conclusion

Dynamic change is a way of life for successful enterprises in Canada. Sharpening Canadians' economic self-image to incorporate this perception is an essential step in developing economic policies that will promote higher levels of employment and improved living standards.

The evidence presented in this chapter has fundamental significance for the choice between interventionist industrial policies and framework policies that seek to improve the general economic and investment climate. The evidence that the majority of new jobs in Canada are produced not by large firms that governments can influence directly but by hundreds of thousands of small firms implies that direct intervention is unlikely to achieve significantly higher employment or promote flexible adjustment. Directing incentives at large firms is a low-risk policy strategy because these firms are unlikely to fail. But the return on such direct incentives in terms of net job creation is also likely to be low.

Channeling direct assistance to small businesses is, however, no panacea. Government strategists cannot hope to identify the one percent (or less) of small firms that will become major job creators. The cost of assisting many thousands of small firms would be excessive and the failure rate high. In fact, small-business organizations say their members want less, not more, government assistance to large and small firms alike. Instead, they argue in favor of general economic policies to improve the climate for investment, risk-taking, and innovation. The policy approach best suited to achieving this objective is one that changes tax, regulatory, and trade policies to reduce the direct assistance and protection such policies provide for a select set of firms and industries while directing capital into the hands of potential new businesses.

3

High Stakes: A Canadian-U.S. Trade Agreement

The federal government's decision to initiate comprehensive trade negotiations with the United States could be the most important Canadian economic policy initiative since the end of World War II.[1] This decision has set in motion internal debate about freer bilateral trade that will intensify in 1986 as the issues to be negotiated and the bargaining positions of the two countries develop.

Emerging from years of consultation and discussion is a fairly widely held consensus that Canada's $155 billion annual two-way trade with the United States must be secured. Debate in 1985 focused on a federal government discussion paper, released in January, that was skeptical of then-current proposals for sectoral free trade with the United States and relatively optimistic about the possibility of a more comprehensive removal of bilateral trade barriers. In the summer, nine of the ten provincial premiers and a Joint Parliamentary Committee recommended that the federal government initiate comprehensive trade negotiations with the United States. Adding considerable weight was the recommendation of the Macdonald Commission and of other independent analyses of Canada's trade options that the best option — the only one that promises a real chance for a major improvement in Canada's competitiveness and economic performance — is a comprehensive bilateral agreement with the United States.[2] But important sources of disagreement and caution exist, particularly in Ontario.

The conclusion that Canada should initiate comprehensive trade negotiations with the United States occurred against a background of increasing protectionist sentiment in the U.S. Congress and an intensification of Canadian-U.S. trade conflicts in specific sectors. The Reagan administration, which has resisted these protectionist pressures, has indicated its interest in the Canadian initiative and is likely to seek congressional approval to pursue negotiations. The desire for the bilateral trade deal,

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[1] The Rt. Hon. Brian Mulroney, Statement to the House of Commons on Canada-U.S.A. Trade Negotiations, September 26, 1985, p. 6.

[2] R.G. Lipsey and M.G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27 (Toronto: C.D. Howe Institute, 1985); and Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], *Report*, vol. 1 (Ottawa: Supply and Services Canada, 1985), pp. 211–377.

however, can be expected to clash with demands on both sides to maintain or increase trade barriers and with quite legitimate concerns about the items that will be "on the table".

This chapter first assesses the environment for the bilateral talks. It then explores the key negotiating issues. Lastly, it suggests a strategic approach that would accept greater discipline in Canada's use of trade and industrial policies in return for equivalent constraints by the United States.

Background to the Bilateral Initiative

The persistence of high unemployment and the uneven nature of the expansion that began in early 1983 have caused Canadians to reassess their future economic prospects. Confidence in the future, which characterized Canadian attitudes in the 1960s and 1970s, has been replaced by a growing uncertainty about Canada's capacity to adjust to the changes that are reshaping the global economic environment.

Among the forces having the most profound effects in reshaping the structure of economic activity are shifts in international comparative advantage, competitiveness, and market access. The rise of import competition from newly industrializing countries (NICs) such as South Korea, Taiwan, and Brazil; the sharp increase over the last five years in the value of the U.S. dollar — and, to a lesser extent, the Canadian dollar — relative to other world currencies; and the increased threat of protectionist actions by the United States and other countries have all created unprecedented pressures for change in industries exposed to international trade.

Canada, like other countries, has sought trade and industrial policies to help cope with these global economic pressures. Its decision to pursue a bilateral trade agreement with the United States is a clear indication that the federal government has chosen an outward-looking strategy of reducing trade barriers and assisting the process of adjustment to a more competitive environment.

In its recent study of Canada's trade policy options, the Institute argues that bilateral trade liberalization would generate sizable net economic benefits for Canada.[3] It would do so by reducing the prices of imported goods to Canadian industry and consumers, by reducing inefficient production practices of Canadian firms currently sheltered by trade barriers, by forcing ongoing adjustment to international competitive forces, and by encouraging investment and innovation by firms that can benefit from improved access to the large, high-income U.S. market.

While these arguments for freer trade are not new, two recent trends

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[3] Lipsey and Smith, *Taking the Initiative*, p. 42.

in the world trading environment have greatly increased Canadian interest in bilateral free trade with the United States. First, the growth of international protectionism signals a breakdown of the rules of the multilateral trading system under the General Agreement on Tariffs and Trade (GATT). Canada has benefited greatly from these rules. Second, a sharp increase in Canadian-U.S. trade frictions in 1985 has increased the risk of a lurch toward protectionism in the United States that seriously threatens Canada's economic performance and political sovereignty.

International Protectionism and the GATT

Protectionism is on the rise worldwide and now threatens to cause a serious breakdown in the liberal trade principles and rules of the GATT. International bodies that monitor the world trade environment unanimously point to the dangers of growing departures from liberal trade policies. A GATT report released in late 1985 argues that there is continuing evidence of a decline in the ability or resolve of governments to make trade policy decisions consistent with their obligations under the GATT.[4] In particular, there has been a proliferation of bilateral protectionism and discriminatory market-sharing arrangements negotiated outside the GATT framework.

The International Monetary Fund (IMF) also points to the drift toward protectionism as one of the most significant threats to the world trading system. The IMF notes that average tariffs on industrial-country imports will drop below 6 percent in 1988.[5] While tariff averages conceal higher rates of effective protection on some commodities, the importance of tariffs as barriers to trade continues to decline. At the same time, however, nontariff barriers (NTBs) have emerged as a serious impediment to world trade. Table 5 provides evidence of the use of nontariff barriers to trade by Canada's largest trading partners during the 1980s. The evidence indicates that the greatest growth in the use of such barriers has been by the United States. U.S. imports facing restrictions accounted for about 6 percent of total manufactured imports in 1980; from 1981 to 1983, such restrictions were extended to other products equivalent to 6.5 percent of total manufactured imports. The use of nontariff measures also increased in Europe, while Japan imposed no new restrictions. The share of consumption of restricted products as a percentage of total consumption of manufactures provides a broader indicator of the coverage of nontariff protection. By this measure, nontariff restrictions covered 20 percent of the U.S. market for manufactured goods in 1980 and new restrictions

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[4] General Agreement on Tariffs and Trade, *GATT Activities, 1984* (Geneva: GATT, 1985).
[5] S.J. Anjaria, N. Kirmani, and A.B. Petersen, *Trade Policy Issues and Developments* (Washington, D.C.: International Monetary Fund, July 1985), p. 22.

Table 5
Measures of Import Restrictions for Manufactured Goods in Selected Developed Countries, 1980 and 1981–83
(percentage of 1980 dollar values)

		Ratio of restricted imports to total manufactured imports	Ratio of consumption of restricted manufactured goods to total consumption of manufactured goods
United States	1980	6.20	20.3
	1981–83	6.52	14.7
European Community	1980	10.80	23.7
	1981–83	4.08	4.7
Japan	1980	7.20	15.7
	1981–83[a]		

Note: Data for 1980 represent restrictions existing in that year. Data for subsequent years represent new restrictions expressed in terms of 1980 dollar values.

[a]Japan imposed no new restrictions in the 1981–83 period.

Source: B. Balassa and C. Balassa, "Industrial Protection in Developed Countries," *The World Economy* 7 (June 1984): 187.

applying to another 15 percent of the market were introduced between 1981 and 1983. Most importantly, the evidence in Table 5 indicates that by 1983, the coverage of nontariff protection of manufacturing was greater in the United States, Canada's dominant trading partner, than in either Europe or Japan.

The rise in protectionism reflects increased resort to four main types of NTBs: quantitative restrictions such as quotas, administrative and bureaucratic procedures such as burdensome customs regulations or national standards, contingent-protection measures such as countervailing and antidumping duties, and voluntary export restraints (VERs). Moreover, the spread of such nontariff barriers has increased the difficulty of measuring the degree of protection in world trade. The Organisation for Economic Co-operation and Development argues that protectionist measures have become less transparent recently because governments have sought to bypass their obligations under the GATT and have not wished to be obvious in departing from liberal trade rules.[6]

Not all countries attempt to disguise their actions to restrict imports. As Table 6 shows, there has been heavy use of highly visible counter-

[6]Organisation for Economic Co-operation and Development, *The Costs of Protectionism* (Paris: OECD, 1985)

Table 6
Countervailing-Duty Actions, July 1982–December 1984
(number of cases)

Initiating country	Actions initiated	Provisional measures adopted	Definitive duties adopted
United States	103	80	37
European Community	4	1	3
Canada	9	5	2
Australia	16	17	0
Chile	62	1	0
Japan	1	0	0

Source: S.J. Anjaria, N. Kirmani, and A.B. Petersen, *Trade Policy Issues and Developments* (Washington, D.C.: International Monetary Fund, July 1985), pp. 110-111.

vailing-duty actions in recent years, especially by the United States. Countervailing duties are a legitimate defense against subsidized imports under GATT rules. Indeed, some economists argue that the use of such legal obstacles to trade has increased partly because GATT codes implemented following the last round of multilateral trade negotiations legitimized their use.[7] The cases reported in Table 6 significantly understate the impact of countervail on the pattern of world trade and investment. The very existence of a mandatory, legalistic, quasi-judicial process of investigating imports can be a significant deterrent to trade because of its potential use as a form of harassment. In order to escape the risk of countervail, firms may choose to invest in the U.S. market rather than to export to it.

A less visible but more serious threat to the GATT system is the increased resort to bilateral protectionism, which comprises VERs and other informal market-sharing understandings. These understandings are reached through bilateral bargaining between the importing and exporting countries. Complaints of "unfair" trade by industries injured by foreign competition have been settled increasingly through market-sharing agreements rather than by resorting to antidumping or countervailing duties permitted under the GATT. This has weakened the commitment to international trade rules and undermined the basic principle of nondiscrimination in international trade policy. Recent examples include VERs on Japanese automobile exports by several countries, including Canada, and on steel exports from Japan, the European Community (EC), and many of the NICs by the United States.[8]

[7] R. de C. Grey, "A Note on U.S. Trade Practices," in W.R. Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983), p. 248.
[8] For a description of these and other moves toward bilateral protectionism, see Anjaria, Kirmani, and Petersen, *Trade Policy Issues and Developments*, pp. 36–55.

The use of VERs is difficult to limit because they serve the purposes of vested interests in both the importing and exporting countries. Domestic producers in the importing country are shielded from more efficient foreign products and thus are able to maintain higher prices, profits, and wages, and to delay adjustment to competitive forces. For the exporter, VERs provide a reduced, but assured, market and often enable them to increase their profits by raising prices to the higher level existing in the protected market. It is because industries in both the exporting and importing countries share the higher profits protection creates that VERs are truly "voluntary" and difficult to control.

U.S. Trade Policy in 1985

The greatest economic threat to Canada in 1985 has been the increasing spread and intensity of protectionist sentiment in the United States. The focus of U.S. protectionist attention is that country's soaring foreign trade deficit, which was running at over $130 billion at annual rates over the first nine months of 1985.[9] Domestic U.S. demand has grown relatively strongly over the past year but rising import penetration has meant that this strong demand has not translated into higher output and jobs for U.S. industry. Indeed, some manufacturing sectors are besieged by more competitive foreign imports.

The trade deficit itself is a symptom of deep-seated problems in the U.S. economy. The real causes are excessive budget deficits combined with low rates of private saving. Because the United States cannot finance both its fiscal deficits and a robust level of private investment out of domestic savings, it must rely on capital inflows from abroad. The surge of capital inflows to the United States propelled the trade-weighted value of the U.S. dollar upward by 60 percent between 1980 and early 1985. Imports from virtually every country became cheaper in the United States while U.S. exports became more expensive abroad.

As noted in Chapter 1, the five largest industrial countries demonstrated their recognition of the underlying causes of protectionism when their finance ministers and top central bankers met in New York in September 1985 and agreed on a plan to lower the value of the U.S. dollar.[10] While this action may help moderate the spread of protectionist sentiment in the United States, it will not reverse the trend quickly. It is important, therefore, to understand the thrust of new measures to restrict imports into the United States.

It is not possible to understand U.S. trade policy pressures without ac-

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[9] "Time to take protectionism seriously," *The Economist*, July 27, 1985, p. 19.

[10] A. Pine, "To Avert a Trade War, U.S. Sets Major Push to Drive Down Dollar," *Wall Street Journal*, September 23, 1985, p. 1.

knowledging the complex institutional process of trade policymaking that exists in that country. The system is a maze in which trade policy is pieced together by the president and his advisers, a dozen government departments and congressional committees, and the legal system.

At the present time, assessing the thrust of U.S. trade policy is made more difficult by the involvement of a president who is committed to free-trade principles, a Congress that is responding to complaints from voters about imports by drafting protectionist legislation, and a bureaucratic, quasi-judicial legal system that, in precedent-setting decisions, determines the meaning of "fair" trade.

The Reagan administration has a reasonably good record of resisting protectionist actions and, in some cases, liberalizing trade. For example, it rejected industry petitions for import relief for copper, tuna, footwear, and machine tools. The administration also won congressional approval to extend the Generalized System of Preferences for developing-country imports and to negotiate a bilateral trade liberalization agreement with Israel. On the other hand, it supported trade restrictions on steel, textiles and clothing, motorcycles, and Japanese autos.

The real protectionist pressures emanate from two sources. The first is U.S. industry, which is learning to take advantage of fair-trade laws. The second is congressmen who draft legislation designed to broaden the definition of unfair-trade practices, to increase the powers of the president and government agencies to investigate imports and implement "remedies", and to pressure the president to make more use of his discretionary powers to restrain imports or open up markets for U.S. exports.

Only a few of several hundred protectionist bills reported to be circulating in Congress in late 1985 are of any real consequence. Many of them are no more than press releases that make Congress sound more protectionist than it really is. But there are some important exceptions — bills that have widespread support and that would cause serious damage to the world trading system if enacted. Areas in which the most significant bills have been introduced are the following:[11]

- *Textiles and clothing.* This bill proposes to cut U.S. imports of textiles and clothing by 20 to 40 percent. It would target three countries — South Korea, Taiwan, and Hong Kong — and force them to cut back on exports to the United States by 30 percent. Most other countries would be limited to their 1984 shipments plus 1 percent growth per year.
- *Footwear.* In reaction to President Reagan's August 1985 decision not to impose restrictions on shoe imports, Congress has added a clause to

[11] For additional details, see "All's fair in love — and trade?" *The Economist*, September 28, 1985, p. 24.

the textile and clothing bill that would limit imports to 60 percent of the U.S. market for eight years.

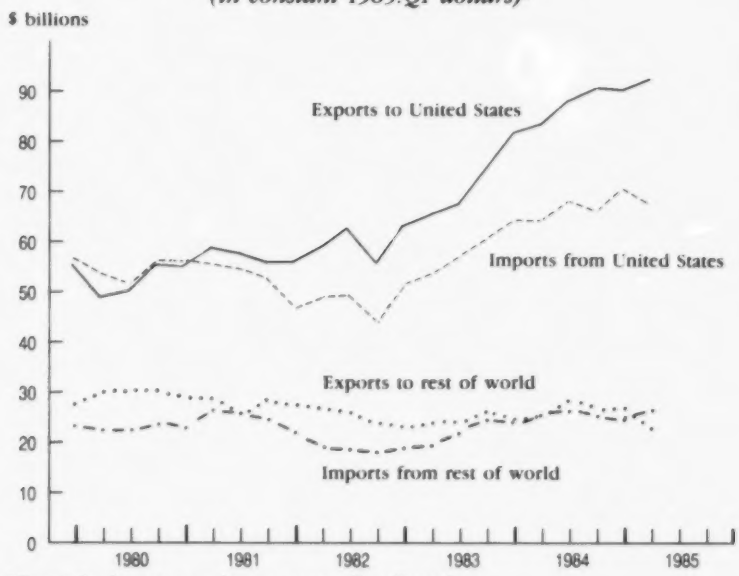
- ***Trade with Japan and the NICs.*** Several bills would target countries that have large trade surpluses with the United States. One bill, proposed by Senator John Danforth, would require the president to report within 45 days on whether Japanese trade practices are fair, and if they are not, to specify what measures he will adopt in retaliation. Another bill, supported by Representative Dan Rostenkowski, Chairman of the influential House Ways and Means Committee, would impose a 25 percent import tax on goods from Japan, Taiwan, South Korea, and Brazil unless these countries reduce their trade surpluses with the United States.
- ***Upstream subsidies.*** Representative Sam Gibbons has proposed a bill that would enable U.S. producers to seek protection from imports that have a cost advantage because of subsidies to natural-resources inputs. A similar bill was defeated in 1984, but the new bill contains a clause intended to provide protection for U.S. softwood-lumber producers that has won it new supporters. The Gibbons bill has broader implications than the current dispute about lumber trade, however, since it is intended to make any discrimination between domestic and export prices for resources products a countervailable subsidy. If successful, such legislation would create important new constraints on the industrial policies of countries that export to the United States. For example, the United States has not regarded controls that keep energy prices below world levels — an important element of the National Energy Program — as countervailable subsidies unless targeted to specific industries such as petrochemicals. Under the Gibbons bill, such policies would become countervailable subsidies under U.S. trade law.

While only the Gibbons bill directly threatens Canadian exports to the United States, each of the important protectionist bills in Congress has serious implications for Canada. Passage of a textiles and clothing bill, coming on the eve of renegotiating the Multifibre Arrangement — which already restricts imports to industrial countries — could seriously erode support by the developing countries for multilateral negotiations and threaten the prospects for progress in a new GATT round. A trade war between the United States and Japan would damage economic growth in both of Canada's largest trading partners. The adoption of such legislation would represent the most serious challenge to the world trading system since the Smoot-Hawley tariff of the Great Depression.

Canadian-U.S. Trade Frictions

Canada's economic expansion since 1983 has been trade-led. The recov-

Figure 3
Profile of Canadian Trade, 1980–85
(in constant 1985:Q1 dollars)[a]



[a]Quarterly data at annual rates, seasonally adjusted.

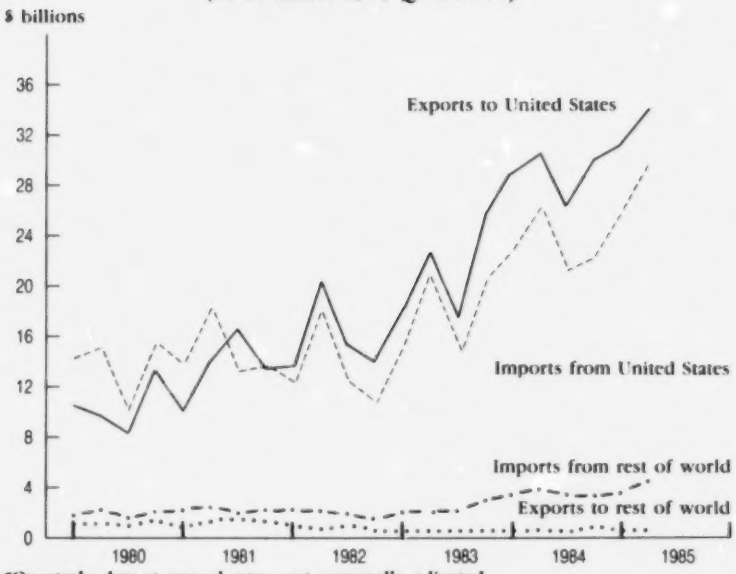
Source: Statistics Canada, *Summary of External Trade*, Cat. no. 65-001, various issues.

ery in the volume of Canadian trade has been heavily concentrated in bilateral trade with the United States, as shown in Figure 3. From the first quarter of 1983 to the first quarter of 1985, total Canadian trade increased by $53 billion in constant 1985 prices, of which $46 billion represented increased trade with the United States. A large part of the increase, $34 billion, was concentrated in Canadian-U.S. trade in motor vehicles and parts, as shown in Figure 4.

The primary reason for this concentration is that the recovery has been much stronger in the United States than in other industrial countries. Other reasons for Canada's increasing reliance on trade with the United States include the increased competitiveness of Canadian goods in the U.S. market — based largely on the relative strength of the U.S. dollar — and the imposition of U.S. restrictions on some third-country imports, such as Japanese automobiles.

Canada thus has become increasingly reliant on the U.S. market. In 1984,

Figure 4
Canadian Automotive-Products Trade, 1980–85
(in constant 1985:Q1 dollars)[a]



[a]Quarterly data at annual rates, not seasonally adjusted.

Sources: Statistics Canada, *Exports by Commodities*, Cat. no. 65-004, various issues; and idem, *Imports by Commodities*, Cat. no. 65-007, various issues.

the United States was the destination of 76 percent of Canada's exports and the source of 72 percent of Canada's imports. In 1980, the comparable figures were 64 percent and 70 percent. At the same time, Canada's merchandise trade surplus with the United States increased to almost $20 billion in 1984 from under $2 billion in 1980, leaving Canada with a bilateral trade surplus with the United States second only to Japan. While this increase in bilateral trade has benefited Canada greatly, the benefits have not come without costs — namely, increased bilateral trade disputes and increased Canadian vulnerability to shifts in U.S. trade policy.

Heightened protectionist sentiment in U.S. industry and in Congress has resulted in a significant increase in bilateral trade frictions, and these are likely to influence any future bilateral trade negotiations. Table 7 presents a list of Canadian exports that were threatened by U.S. trade actions in 1984 and 1985. Canadian exports of 12 threatened commodities

totaled $7 billion in 1984. Three commodities — carbon steel, softwood lumber, and fish — accounted for over 80 percent of this amount.

Steel

Although ostensibly exempted from President Reagan's September 1984 decision to impose VERs on steel from Japan and 13 developing countries, Canadian steel producers have been pressured to reduce shipments to the U.S. market.[12] Combined with an earlier restraint agreement between the United States and the EC, this decision left Canada as the only major supplier of steel to the United States not forced to negotiate a formal agreement restricting exports. Nevertheless, Canadian steel exports are subject to informal restraint, since the United States is striving to limit overall imports to 18–20 percent of the U.S. steel market. Since May 1985, the United States has been monitoring steel imports from Canada to ensure that they do not increase their 3 percent share of the U.S. market. In August 1985, the United States included Canada in a list of countries that had expanded exports of finished steel products, thus undermining the effectiveness of the president's program to restrain steel imports.[13]

Statements by U.S. trade officials that Canada is exporting too much carbon steel, despite reductions in Canadian exports, raise the specter of formal restraints and put pressure on Canadian companies to reduce steel exports even further. At the same time, countries subject to formal steel export-restraint arrangements obtain immunity from other U.S. trade laws in the sense that as long as they abide by their overall quota, they are not subject to U.S. antidumping or countervailing-duty actions. But Canadian companies trying to match the prices of these producers from other countries are threatened by such U.S. trade laws. Furthermore, Canadian exporters risk being included in antidumping cases aimed primarily at other steel-producing countries — such as Turkey, Sweden, and Taiwan — that, like Canada, are not covered by U.S. restraints and that have been increasing their exports to the United States.

Lumber

The most serious threat to Canadian exports in 1985 arose from renewed lobbying efforts by U.S. lumber interests to restrict imports of softwood lumber. Early in 1985, a bill was introduced in Congress that

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[12] The steel decision was analysed in E.A. Carmichael, *Time for Decisions*, Policy Review and Outlook, 1985 (Toronto, C.D. Howe Institute, 1985), pp. 56–58.

[13] "Steel Import Relief Seen," *New York Times*, September 5, 1985, p. D22; S. Auerbach, "Steel Import Problem Said to Persist," *Washington Post*, September 5, 1985; and "U.S. raps increase in exports of our steel," *Toronto Star*, September 5, 1985, p. E1. A U.S. official was quoted as saying: "The Canadians assured us they would be prudent. We are keenly disappointed by the volume of imports from Canada."

Table 7
Canadian Exports Subject to U.S. Trade Actions, 1985

Product	Value of exports to United States, 1984 ($ millions)	Type of U.S. trade action	Current status
Softwood lumber	3,271	Legislative attempts to reduce imports from Canada	Several bills before Congress
Carbon steel	1,329	VER agreements with thirteen countries	Imports from Canada currently under surveillance
Atlantic fish	754	Countervail investigation	Preliminary injury ruling made
Hogs and pork	517	Countervail investigation	Duties imposed on hogs
Iron and steel pipes and tubes	331	a) Country-of-origin marking requirement introduced; b) Antidumping and countervail investigations	Canada adopted identical requirements in July 1985; Investigations still in early stages
Softwood shingles and shakes	260	Escape-clause investigation	Investigation in early stages
Sugar and products containing sugar	164	Quotas imposed to protect U.S. price-support system	Coverage narrowed but quotas remain effect until Sept. 30, 1986
Rock salt	29	Antidumping investigation	Final decision due January 1986
Salt cod exported to Puerto Rico	12	Antidumping investigation	Duties imposed
Raspberries	9	a) Antidumping investigation; b) Countervail investigation	Duties imposed Investigation in progress
Specialty steel products	n.a.	Quotas imposed in 1983	Quotas remain in effect until 1988
Eggflats	n.a.	Antidumping investigation	No injury found in final ruling; appeal in progress

Sources: Statistics Canada, *Exports: Merchandise Trade, 1984*, Cat. no. 65-202 (Ottawa, 1985); and C.D. Howe Institute.

would have restricted Canada's share of the U.S. softwood-lumber market to about 22 percent, a significant reduction from the 31 percent present share. The bill, which contravened U.S. international obligations under the GATT, did not receive widespread support in Congress and was shelved.

An alternative approach was to alter U.S. trade laws in order to overturn a 1983 ruling that found Canadian stumpage practices not to be countervailable subsidies. One such attempt, the Gibbons bill — which has a reasonable chance of passing — would require a complicated administrative calculation by the U.S. International Trade Administration of the difference between actual stumpage payments and an estimate of their market value in Canada. The difference would be deemed a countervailable subsidy. If the 30 to 60 percent duties cited by advocates of the bill were imposed on Canadian lumber exports to the United States, the consequences for an already hard-pressed Canadian lumber industry would be devastating. Several congressmen and administration spokesmen have argued that negotiations on a bilateral Canadian-U.S. trade agreement are not possible until the lumber issue is resolved.[14]

Fish

Another bilateral trade dispute emerged in August 1985, when the New England fishing industry filed a petition for countervailing duties against the Canadian Atlantic fisheries. The petition alleges that the Canadian industry receives 80 different types of government subsidies, including special unemployment insurance benefits and regional development grants. An earlier study had calculated subsidies of about 10 percent on groundfish from Eastern Canada.[15] A ruling on the magnitude of countervailable subsidies to the Canadian industry is expected in January 1986.

Although it can be argued that Canadian subsidies to its fishing industry do not cause injury to U.S. fishermen because the total catch is restricted by a Canadian quota, the risk of countervailing duties is great. The Atlantic fisheries already have had a difficult year because of a poor catch and some fish plants have gone into bankruptcy. The potential imposition of U.S. countervailing duties in 1986 would compound the industry's problems and increase unemployment in many communities in the Atlantic region.

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[14] J. Lewington, "Free-trade call welcomed, but U.S. moves cautiously," *Globe and Mail* (Toronto), September 27, 1985, p. 3.

[15] United States, International Trade Commission, *Conditions of Competition Affecting the Northeasten U.S. Groundfish and Scallop Industries in Selected Markets* (Washington, D.C., December 1984), p. 198.

Book Publishing

The most contentious bilateral issue in 1985 resulting from Canadian government policy was an investment rather than a trade issue. In 1984, Gulf & Western acquired Prentice-Hall, a large U.S. publisher with a subsidiary in Canada. As an indirect acquisition, this transfer of ownership of the Canadian subsidiary was subject to review under the *Foreign Investment Review Act* (FIRA). In December 1984, when the Investment Canada legislation was introduced, it was proposed to tighten review procedures for culturally sensitive industries such as book publishing and film distribution at the same time that investment in other sectors was encouraged.[16] Since a decision had not been made under FIRA on the ownership transfer of Prentice-Hall, it became reviewable under the Investment Canada legislation.

In July 1985, the government announced a new policy to promote Canadian ownership of book publishing and film distribution. The policy allows indirect takeovers in which one foreign-owned company takes over the Canadian subsidiary of another foreign-owned company, on the condition that the new foreign owner turns control over to Canadians within two years, at "fair market price". The Prentice-Hall case became controversial because of U.S. objections to the retroactive nature of the new restrictions and their impact on indirect acquisitions.[17]

How the book-publishing issue is dealt with could have important consequences for the bilateral trade negotiations. Starting the negotiations is proving to be a fragile process in both countries. On the Canadian side, there is a concern that cultural interests not be compromised by the trade negotiations. In the United States, the perception that Canada has retroactively changed the rules governing foreign investment in one key sector is reminiscent of the contentious National Energy Program. These changes may be seen as a harbinger of similar initiatives in other sectors and could damage the chances of gaining congressional approval for the negotiations.

Other important disputes in 1985 involved steel pipes and tubes, hogs and pork, refined sugar, and food products containing sugar. Not all of these frictions were the result of U.S. actions. For its part, Canada imposed a little-used law to keep out imports of beef from the United States and other countries. Moreover, Canadian firms launched a number of antidumping actions against U.S. producers.

The spread of bilateral trade frictions demonstrates the uncertainty

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[16] Investment Canada, *News Release*, December 7, 1984.

[17] "Shultz Reaffirms Administration's Trade Position" (Transcript of a press conference given by Secretary of State for External Affairs Joe Clark and U.S. Secretary of State George Shultz, Calgary, October 29, 1985). See also J. Partridge, "Publishing policy imperils U.S. ties, ambassador says," *Globe and Mail* (Toronto), November 4, 1985, p. A1.

producers face when considering investing in Canada to supply the North American market. The risk of U.S. actions to curtail Canadian exports has increased for virtually all industries, not just those listed in Table 3. Until these risks are reduced, measures to improve the investment climate in Canada are likely to be of limited success.

In summary, while the risks posed by the status quo present a major motivation for bilateral trade negotiations, there are longer-term strategic reasons for pursuing this route as well. Canada's industrial structure must be rationalized so that its products are complementary to, not competitive with, those of the NICs. This process should occur in an environment of growth such as may be possible in a free-trade area. The negotiations should be a means to that end, not an end in themselves.

Preparing for the Negotiations

Canada's trade initiative has set in motion a negotiating process that, in spite of being called the "fast-track" approach, could take two years to complete. The advantages to Canada of this process are that it ensures timely consideration of the Canadian initiative and that it eliminates the potential for last-minute amendments by Congress. Under the fast-track approach, it is expected that President Reagan will seek congressional approval before beginning formal trade negotiations. When this *Policy Review and Outlook* was being written, Reagan administration officials still were sounding out congressional leaders on their attitudes toward trade negotiations before seeking approval to proceed.

Once informed of the president's intentions to enter into negotiations, Congress has 60 days to either approve or block the negotiations.[18] During this period, two congressional committees with responsibility for trade policy — the Senate Finance Committee and the House Ways and Means Committee — will hold hearings and use the results to decide whether or not to approve the negotiations. Before formal negotiations begin, two other bodies — the Office of the U.S. Trade Representative and the U.S. International Trade Commission — are expected to hold hearings to gather evidence to assist U.S. negotiators in formulating their strategy.

If congressional approval to negotiate is granted, the president can proceed to formalize an agreement with Canada. Once such an agreement has been reached, the president must submit it, along with implementing legislation, to Congress for approval. Congress then has 90 legislative days to accept or reject the bill in its entirety. Under the fast-track ap-

[18] There are varying legal interpretations of the sections of U.S. trade law dealing with the process of gaining congressional approval for bilateral negotiations. Under one interpretation, the administration might need to seek congressional approval only when the negotiations are well advanced.

proach, Congress does not have the option of amending or delaying the agreement.

In Canada, the federal government is gearing up its own consultative mechanism, which is expected to involve a federal-provincial task force to ensure provincial government participation and a private-sector advisory committee.[19] Once consultations have taken place on both sides, the prime minister and the president will meet, perhaps as early as March 1986, to review the potential for striking a mutually beneficial agreement.

Key Negotiating Issues

The key negotiating issues and the bargaining strategies of the two countries are now being developed. Several features of Canada's objectives are already quite clear. In a statement to Parliament, the prime minister indicated that Canada is not proposing "a customs union, a common market or any other economic arrangement which would affect our own independence or our relations with the rest of the world."[20] Canada has made it clear that the objective is limited to negotiating a broad package of reductions in tariff and nontariff barriers that limit trade between the two countries, which probably means a free-trade area (FTA) as defined under Article XXIV of the GATT.[21]

The advantage for Canada in seeking an FTA, rather than the closer associations, is that an FTA is specifically designed to reap the advantages of free trade without requiring the partners to harmonize fully other economic policies between each other or those directed at third countries. A key negotiating issue, however, will be that of trading off the ability to protect some domestic industries in return for increased and more secure access to export markets for other industries. As one Canadian commentator has pointed out,

> Canada would, of course, accept new disciplines over its trade policy but only in exchange for equivalent constraints accepted by the U.S. Government and approved by Congress. In this sense, such bilateral trade arrangements are well in line with Canadian trade poli-

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[19] The Canadian Labour Congress announced in early October 1985 that it would not participate in the advisory committee.

[20] Mulroney, Statement, p. 7.

[21] GATT Article XXIV 8 (b) defines an FTA in the following words: "A free trade area shall be understood to mean a group of two or more customs territories in which duties and other restrictive regulations on commerce [except for special purposes defined by the GATT] are eliminated on substantially all trade between the constituent territories in products originating in such territories."

cies and objectives over the past half-century.[22]

At the outset of the discussions, both countries are likely to cover issues on as broad a basis as possible. But considerable confusion has already arisen in Canada about what will be "on the table". For example, Canada has indicated that it is not prepared to discuss or negotiate changes in such sensitive areas as social programs and cultural activities or in some industrial sectors and aspects of economic policy such as the auto pact.[23] Pressures are expected from other industries, such as clothing and textiles, already under strong competitive pressures from offshore producers, which might also lobby for exclusion.

On the U.S. side, some have argued that exempting Canada from U.S. countervail, antidumping, or safeguard laws is out of the question when the thrust of much current legislation is to make U.S. trade laws tougher and more accessible to U.S. companies. In the case of the U.S.-Israeli free-trade negotiations, Congress excluded U.S. trade laws from the discussions. The United States is also likely to seek exemptions because of national-security considerations. Certain U.S. industries also are likely to lobby for exemption from the negotiations. U.S. shipping interests, for example, can be expected to lobby for retention of the Jones Act, which restricts coastal shipping to vessels registered in the United States, and will probably seek to remove this issue from the table.

This tendency by both countries to take issues or industries off the bargaining table before discussions begin puts unnecessary constraints on the process and limits the scope for achieving a mutually beneficial agreement. A better option for both countries is to begin the process with almost all items up for discussion. The criterion for such discussions should be whether the items in question are intended to distort trade. By this criterion, it would quickly become apparent, for example, that Canada's social programs and many of its cultural activities should not even be on the table.[24] The nature of the bargaining process then should be to determine how far both sides are willing to go toward an FTA, with exclusions being defined in the process of negotiations.

Within the general objectives and framework for the discussions, a number of key issues are likely to be the subject of intense negotiation. As the smaller partner, Canada has the most at stake. Its negotiating objectives and strategy, therefore, will be of utmost importance in seeking an

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[22] F. Stone, of the Institute for Research on Public Policy, quoted in R. Anderson, "U.S. protectionist stance spurs need for free trade," *Globe and Mail* (Toronto), August 21, 1985, p. B5.

[23] M. Cohn, "Auto pact will stay, Clark vows," *Toronto Star*, September 28, 1985, p. 1.

[24] "Social programs not at risk, U.S. envoy says," *Globe and Mail* (Toronto), September 30, 1985, p. 4.

agreement that serves its economic interests and that preserves its cultural and political interests successfully. Detailed issues that will arise and tradeoffs that will have to be made include such matters as the timetable for reducing tariffs, negotiation of bilateral rules governing contingent-protection measures and the use of subsidies, rules governing the treatment of foreign investment, government-procurement policies, and specific industrial issues — particularly those relating to agriculture, cultural industries, and services.

Tariff Reductions

The free-trade-area concept would mean eventual elimination by both countries of nearly all bilateral tariffs. One key issue for negotiation is the rate at which tariffs would decline. Because Canadian tariffs are consistently — for some products substantially — higher than U.S. tariffs, Canadian industries eventually will lose more protection than will U.S. industries from tariff removal. This means that where tariffs now are significant, Canadian industries would face greater adjustment to remain competitive. Because of Canada's potentially greater adjustment problem, its interests will be best served by a more gradual phaseout of tariffs in Canada than in the United States. Although the Macdonald Commission recognizes the need for a phaseout, it argues that Canadian tariffs "only serve to insulate Canadian industries from the world marketplace even when they don't need it," implying that tariff reduction, as long as it is gradual, is in Canada's interest no matter how quickly U.S. tariffs decline.[25]

Contingent-Protection Measures

The greatest obstacle to Canada's negotiating objective of securing access to the U.S. market is the aggressive application of U.S. countervailing duties and other contingent-protection measures, and the growing tendency of U.S. companies to seek "temporary" import relief when under intense pressure from import competition. This relief can take the form of emergency safeguard measures such as temporary tariffs or quotas implemented under GATT rules. The more usual route, however, is for the United States to seek VER agreements with suppliers.

A key objective for Canada, then, is to obtain restrictions on U.S. contingent-protection laws that pose particular problems for Canadian industries. It is doubtful, however, that the United States would be prepared simply to exempt Canada from its contingent-protection laws for two reasons. First, the United States is concerned about Canada's own

[25] Macdonald Commission, *Report*, vol. 1, p. 264.

frequent resort to subsidies. Second, it already refused to consider such a course in its free-trade negotiations with Israel.

Canadian negotiators, therefore, are likely to have to find a creative compromise. One course of action would be to seek U.S. agreement to apply countervail only to the differential between subsidies available to firms in the two countries. This approach would go a long way toward implementing the concept of the level playing field fervently promoted by fair traders in the Reagan administration and in Congress. Another option would be to negotiate a list of subsidies that would be excluded from countervailing duty actions.

With respect to emergency safeguard actions, Canada could bargain for a formal exemption from such actions unless Canadian exports were found to be the primary cause of injury to U.S. firms. This would help to avoid such frictions as occurred in the steel case, when the Canadian industry was "sideswiped" by an action against other countries. An agreement by the two countries not to seek voluntary restraints on each other's exports would be in the interests of both. Failure to discipline the use of such discretionary protective instruments would seriously undermine the potential benefits of freer trade.

Curtailing the use of countervailing duties might require both countries to agree to limit resort to certain types of subsidies. Canadian critics of the free-trade area idea have argued that an agreement to limit the use of subsidies would severely constrain Canada's ability to achieve industrial and regional development objectives. This view fails to recognize, however, that Canadian subsidy policies already are under intense pressure from the threat of countervailing duties, as in the case of the Atlantic fisheries. Current pressures, in fact, could be eased significantly if both countries could agree on an acceptable definition of a countervailable subsidy. A mutually agreed-upon definition would help both countries to establish a level playing field and reduce trade frictions.

Foreign Investment Policy

Canadian screening of foreign investment is likely to be less of an issue to U.S. negotiators than it would have been before the replacement of the Foreign Investment Review Agency (FIRA) with the less restrictive Investment Canada. But the issue still is likely to arise because all foreign takeovers of Canadian companies with assets of over $5 million are still subject to "FIRA-like" review. The United States' objective is likely to be two-fold. First, it will probably seek national treatment for foreign investors. It objects to Canada's practice of reviewing the takeover of a U.S. firm's Canadian subsidiary with assets of over $50 million by another U.S. firm, even when there is no change in the level of foreign ownership in Canada. Second, it is likely to seek a specific undertaking to halt *retroac-*

tive application of regulations. Restrictions on foreign investment in publishing currently are an irritant in Canadian-U.S. relations because the United States objects to the retroactive features of the Prentice-Hall case.

Procurement Policies

At their Quebec City meeting in March 1985, Prime Minister Mulroney and President Reagan made a commitment to the objective of national treatment in procurement — that is, treatment just as favorable for the other country's suppliers as for suppliers in the home country. There will be considerable pressures in the United States to retain preferential-procurement and "Buy-America" policies, which are important to U.S. industries such as steel and urban-transit equipment that are loathe to face Canadian competition. Not only is the U.S. government-procurement market much larger in absolute terms than the purchases of Canadian governments, but, in Canada, provincial governments account for proportionally more of public procurement. Thus, pressures to retain some elements of "Buy-America" policies are likely to be intense unless Canadian provincial governments are prepared to participate in the agreements.

Industrial Issues

Difficult negotiating issues could arise in three specific sectors: agriculture, cultural industries, and services.

Agriculture

Both Canada and the United States have complicated subsidy and price-support systems for different agricultural commodities. In Canada, for example, import quotas and interprovincial restrictions on trade in poultry and dairy products are a key element in the operation of marketing boards that manage supply and support farm prices. At the same time, the United States has highly restrictive import policies for dairy and sugar products. Trade in some commodities — such as cattle and hogs — is relatively unimpeded, although the United States recently imposed a countervailing duty on Canadian hog exports.

Bringing these highly regulated commodities within the scope of a bilateral agreement will meet resistance from producer groups. If, however, freer bilateral trade is implemented on a gradual basis, the adjustment costs to farmers will be much less severe. The questions of which agricultural commodities are to be included in a bilateral agreement, and over what time frame, are likely to be important negotiating issues.

There are several options for this aspect of the negotiations. One would be to exclude commodities that are highly regulated on both sides of the border from the overall agreement. Another would be to include most

agricultural commodities within the overall agreement but to implement elements of the agreement slowly, in the hope that bilateral trade liberalization occurs in conjunction with some progress toward multilateral trade liberalization, which would benefit farmers in both countries. A third option would be to include most agricultural commodities within the bilateral agreement in conjunction with the removal of interprovincial barriers and the dismantling of marketing boards.[26]

Cultural Industries

The treatment of cultural industries and cultural-support policies will be another important issue in the negotiations. Indeed, an important aspect of this issue will be to define cultural industries and policies. Many Canadians will argue for a blanket exemption for cultural industries and all existing policies to promote Canadian content. To many Americans, such Canadian policies as the denial of income-tax deductions for advertising on U.S. border television stations appear to be discriminatory practices that do not necessarily promote Canadian culture.[27]

It ought to be possible to draw a distinction between policies that protect Canadian cultural industries by restricting the flow of information and cultural services into Canada and policies that promote indigenous Canadian cultural expression.[28] In the book-publishing case, for example, the question is whether or not the objective of promoting the publication of Canadian-authored books can be achieved by policies that do not restrict foreign investment. One option would be to subsidize Canadian authors or Canadian-owned publishers directly. Should Canada seek a blanket exemption for cultural industries, however, an agreement that balances the interests of both countries might be more difficult to achieve.

Services

U.S. negotiators have identified the reduction of barriers to trade in services as a key objective in any future round of multilateral trade negotiations. An across-the-board approach to liberalizing trade in services would be difficult because of the diversity and complexity of regulatory policies. Many of the barriers to freer trade in services are the result of different regulatory policies in the two countries. Freer trade in transportation or financial services, for example, would require greater harmonization of regulatory policies in each sector. Even without free trade, strong pressures exist for Canadian industries such as airlines, railways, trucking,

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[26] Ibid., vol. 2, pp. 430–432.

[27] D. Leyton-Brown, *Weathering the Storm: Canadian-U.S. Relations, 1980–83*, CAC no. 51 (Toronto; Washington, D.C.: Canadian-American Committee, 1985), p. 68.

[28] Macdonald Commission, *Report*, vol. 1, p. 366.

and long-distance telephone communications to follow U.S. moves toward deregulation. For these reasons, any negotiations likely would have to be conducted on a sectoral basis, perhaps by separate negotiating teams made up of experts in regulatory issues.

Two specific areas in which the United States has indicated an interest in liberalizing trade concern the operations of U.S. banks and other financial institutions in Canada, and Canadian laws on patents and copyright.

One precedent for bilateral negotiations on services trade that should be considered is the recently concluded U.S.-Israeli free-trade agreement. Both parties agreed to broad principles for trade in services, including right of establishment and national treatment. The agreement provides for sector-by-sector negotiations on application of these principles.

Summary

This assessment of negotiating issues suggests that both Canada and the United States will have to accept limits on their trade and industrial policies if they wish to gain increased access for their exports and their investment in the other country. If an agreement is to be reached, both countries will have to make concessions to discipline their use of trade-distorting policies.

If Canada is to achieve its main objectives — a slower phaseout of tariffs and relief from future application of U.S. contingent protection — it can expect to be asked to limit its use of industrial subsidies, to explore the removal of barriers to trade in services, and to limit the screening of foreign takeovers.

Key questions that many Canadians ask are: What is in this for Americans? Why should they yield to Canadians what they have already refused Israelis? One U.S. objective is a strategic one. A bilateral free-trade agreement at this time could help reverse the damaging tide of international protectionism and provide a model for trade liberalization with other countries that could serve U.S. interests in preserving an open international trading system. The specific U.S. objective in its negotiations is likely to be achievement of a more level playing field between the two countries. To achieve this objective, however, Canadians will insist that the United States constrain its future application of countervailing duties and agree to restrict its use of emergency safeguard actions and VERs in dealings with Canada. A central question is whether the United States will agree to such a constraint. If it refuses, the benefit to Canada of negotiating the removal of other trade barriers would be limited because of the continuing threat to Canada's interests of aggressive application

of U.S. trade laws.[29] If the United States does agree, then removing tariffs, containing the use of nontariff barriers, and limiting restrictions on trade in services and foreign investment will benefit both countries. Phasing in the new rules gradually will provide sufficient time for industries in both countries to plan ahead to take advantage of increased and more secure market access. For Canada, removing the uncertainty associated with the application of U.S. trade laws will encourage investment, and reducing tariff and nontariff barriers will help direct that investment into its most productive use.

The Task For Canada's Negotiators

Canada's negotiators face a difficult and uncertain task. They will have to consult extensively with business, labor, regional, and cultural interests to ensure support for Canada's market-access objectives and to anticipate and prepare for the adjustments that will be required by lower Canadian tariffs and reduced nontariff barriers to trade. Compromises on the treatment of investment, the use of other nontariff barriers, and policies affecting trade in services are likely to require breaking new ground by involving the provinces in the negotiating process.

Canada's negotiators will also have to coordinate their objectives and solutions in bilateral negotiations with future GATT negotiations. Canada's long-term interests will be best served by establishing this linkage, and it will also strengthen Canada's bargaining position. If an acceptable bilateral agreement should prove impossible to negotiate, Canada will have to seek enhanced and more secure access to world markets, including the United States, through the multilateral process.

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[29] By the term "aggressive application", we mean using countervail as a means of harassing importers or when there is no differential advantage conferred by foreign countries' subsidies. Because of the high degree of interdependence between Canada and the United States, the application of U.S. trade laws has created unnecessary frictions in their trade relations.

4

Rewarding Initiative: Reform of the Tax and Transfer System

Individuals and firms make important economic decisions based on the incentives created by the tax and transfer system: they are encouraged to alter their behavior to reduce the amount of tax they have to pay or to increase the benefits they receive from transfer programs. Over the years, transfer payments and tax policy have evolved independently of one another, although both have had important consequences for economic incentives and income distribution. As new measures have been introduced, insufficient attention has been paid to their impact on economic incentives. The result has been an *ad hoc* accumulation of social transfers and tax provisions that discourage efficiency and growth.

Tax and transfer policies are highly sensitive issues in Canada. Private tax specialists and the federal government have been wary of even discussing comprehensive national tax reform since the ill-fated November 1981 budget. Some tax experts liken the tax system to a complex piece of high-technology equipment and argue that tinkering with the system can have quite unexpected negative results. Many felt after the November 1981 budget that business confidence and investment would benefit from a period of stability in tax policy. Similarly, proposals for reform of transfers, such as those relating to the old age pension and family benefits made in 1985, have met with stiff political resistance.

So far, the federal government has downplayed the need for reform of tax and transfer policies and given it a low priority on its economic policy agenda. Instead, it has emphasized maintaining a stable environment to encourage investment. Even so, significant changes to the tax and transfer system have occurred. The changes already announced, and those under consideration, represent a major restructuring of the incentive system in Canada. The impetus for these changes has arisen not from a well-defined comprehensive strategy but from a diverse set of political pressures, administrative problems, and revenue objectives. The end result could be that Canada gets tax changes that do little to correct, and may even worsen, the serious flaws in the system.[1]

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[1] While the flaws in the tax and transfer system represent a significant obstacle to efficiency and growth, some analysts have been overly pessimistic about recent changes in Canadian tax policy. See, for example, A. Reynolds, "Will Canada Cut Its Economic Throat?" *Wall Street Journal*, June 11, 1985, p. 26.

This chapter outlines the ways in which Canada's tax and transfer system alters incentives and distorts resource allocation. It then looks at two new, comprehensive approaches to reforming the system: the Quebec government's *White Paper on the Personal Tax and Transfer Systems* and the Macdonald Commission's recommendations for changes to tax policy and for the introduction of a Universal Income Security Program.[2] Finally, the chapter assesses the tax changes that the federal government has proposed or is considering.

Restructuring the Incentive System

In assessing options for reform of Canada's tax and transfer system, it is critically important to keep in focus the strategic objectives that policy is expected to promote. The federal government has built its policy approach on the assumption that the private sector is to be the engine of economic growth. But, if the private sector is to fulfill that role, the government must provide a climate that encourages growth. The tax and transfer system plays a central role in determining that climate because of its influence on the structure of incentives facing firms and employees in the private sector.

There are three fundamental ways in which the tax and transfer system can contribute to achieving the strategic objective of stronger private-sector growth. First, it can promote saving and mobilize these savings into productive private investment. Second, it can ensure that tax rates are not so high as to discourage work effort, adjustment, innovation, and entrepreneurship. Third, by ensuring that transfer payments and tax provisions are well targeted to meet their objectives, it can reduce the threat to Canada's medium-term growth prospects posed by continuing large budget deficits.

The current tax and transfer system will not contribute effectively to stronger growth if it cannot meet these criteria. Our assessment of the current system leads us to the following conclusions:

- ***It distorts investment decisions.*** The tax system causes investors to

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[2] Quebec, Ministère des Finances, ***White Paper on the Personal Tax and Transfer Systems*** (Quebec, 1984); and Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], ***Report***, vol. 2 (Ottawa: Supply and Services Canada, 1985), pp. 206–209, 771–803. For background on the Commission's tax-reform proposals, see R. Boadway and N. Bruce, "Theoretical Issues in Tax Reform," in D. Laidler, ed., ***Approaches to Well-Being***, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada, no. 26 (Toronto: University of Toronto Press, 1985), pp. 137–193; and F. St.-Hilaire and J. Whalley, "Reforming Taxes: Some Problems of Implementation," in idem, pp. 195–224.

waste resources on low-yield investments that carry large tax benefits, while some high-yield investments without such benefits are discouraged. According to the Department of Finance, the marginal corporate tax rate on different categories of fixed investment ranges from −6 percent to 40 percent.[3] With such a wide range of marginal tax rates, investment decisions tend to be based more on tax considerations than on the underlying productivity and profitability of the investment.

- *It discourages and distorts saving decisions.* If income is saved in the form of RRSPs or RPPs, the funds saved are deductible from taxable income. Other forms of saving — bank deposits, stocks, bonds, for example — do not receive such favorable treatment. This feature of the tax system causes two types of distortions. First, the fact that most forms of saving — and associated interest and dividend income — are included in current taxable income means that the tax system imposes a heavier burden on people who save income for later consumption than on those who spend their income as they earn it. Thus, saving is discouraged. Second, RRSP and RPP provisions cause individuals to channel savings into these instruments to reduce their taxes. In the process, a large portion of Canada's savings flow into large, risk-averse institutions, thereby reducing individual risk-taking, entrepreneurship, and innovation. Furthermore, the current system does not permit individuals to claim the dividend-tax credit on funds held in such plans and, therefore, it provides a strong disincentive to equity investment.
- *It penalizes work.* Canada's existing tax and transfer system acts as a disincentive to work in several ways. The large number and value of deductions, exemptions, and credits in the tax system not only creates inefficiencies but also erodes the tax base. This erosion of the tax base means that to collect a given amount of revenue, tax rates must be increased. Economists who have evaluated tax-reform proposals in Quebec point to a wide range of work-related distortions caused by the higher rate of personal income tax that exists in that province than elsewhere in Canada:

> It will stimulate the growth of part-time jobs instead of full-time employment, and the creation of temporary rather than permanent jobs; it will encourage unions to demand shorter work hours, and increased remuneration in the form of nontaxable fringe benefits. It will tend to push up the rate of absenteeism, will encourage people to delay their entry into the labour market and to retire at a younger age. The quality of manpower will suffer, since there is a disincen-

[3] Department of Finance, *The Corporate Income Tax: A Direction for Change* (Ottawa, May 1985), p. 15.

tive to invest in education and vocational training. Furthermore, it has a bearing on individual choice concerning occupational and geographical mobility, and will tend to encourage work in the underground economy.[4]

Additional disincentives to work can arise from the transfer system. Programs such as unemployment insurance, social assistance, and welfare give rise to what economists call "implicit" tax rates. These are the rates at which program benefits are reduced as income from employment increases. It is not uncommon for people on welfare or unemployment insurance to face implicit tax rates in excess of 75 percent, which means that for every dollar of income earned when a person returns to work, income from transfers is reduced by 75 cents or more. When the implicit tax rate is so high, the incentive to return to work is greatly reduced.

- *It worsens the deficit.* Features of the tax and transfer system contribute to a structural imbalance between federal revenues and expenditures. The exemptions, deductions, and credits included in the tax system erode the federal tax base and make it more difficult to deal with the deficit on the revenue side. The disincentives to work created by the existing transfer system encourage dependence on such programs and make expenditure reduction more difficult. Under current policies, the federal government faces deficits of $25–35 billion throughout the rest of this decade and into the next. As Canadians found out in 1985, failure to cut government spending means that taxes have to rise just to contain the growth of the deficit. The government chose to increase revenues by raising tax rates — a decision that will make the distortions already mentioned even more severe. The risks are further intensified because the United States appears poised to move to a system incorporating significantly lower tax rates. Canada now must choose between raising taxes or reforming the tax and transfer system to help gradually reduce the built-in structural budget deficit.
- *It is complex and unfair.* To the average taxpayer or transfer-payment recipient, the system appears complex and often unfair. The many special incentives built into the tax system add to the perception that corporations and the rich do not pay their fair share because they can hire tax specialists to help them legally avoid taxes. All taxpayers face higher tax rates than would otherwise be necessary to compensate for the revenue lost from special tax provisions used by a relatively small number of taxpayers. The current system of transfers consists of a complex patchwork

[4] B. Fortin and H.-P. Rousseau, *Economic Evaluation of the Options in the White Paper on the Personal Tax and Transfer System: A General Equilibrium Approach* (Quebec: Université Laval, Département d'économique, Groupe de recherche en politique économique, December 1984), p. vi.

of overlapping programs. Both supporters and critics of social transfers recognize that they are ineffective in reducing poverty and often poorly targeted to low-income individuals.

These flaws in the existing system are widely recognized. The features of the system that discourage and distort private saving and investment, that penalize work, and that contribute to the federal deficit problem all represent obstacles to stronger private-sector growth. What is less clear is the best way of improving the system. Two quite different routes to reform have been proposed in 1985. One is the comprehensive route. Two new proposals for comprehensive reform of the system were made — one by the Quebec government, the other by the Macdonald Commission. While these proposals address the fundamental problems of the existing system, they also represent major changes in the status quo and are likely to encounter political resistance.

The second route is that of piecemeal reform. In the May 1985 budget, the federal government announced a $500,000 lifetime capital-gains exemption to encourage risk-taking; it partially de-indexed the personal income tax and family allowances to help reduce the budget deficit; it proposed a minimum personal tax to meet concerns about equity; it is considering a value-added tax as a way of removing distortions created by the manufacturers' sales tax; and it proposed an overhaul of corporate income tax to reduce distortions to investment. Canada's experience with tax and social policy reform suggests that incremental change to the system is the only politically feasible way to proceed. The problem with this piecemeal approach, however, is that in attempting to resolve some of the flaws in the current tax system, others can be compounded.

Comprehensive Approaches to Reform

Canada is not unique in having a tax system that creates inefficiency and that is viewed as complex and unfair. Similar problems are present in the tax systems of most industrial countries and pressures for reform are strong. Different countries and jurisdictions are responding to these pressures in various ways.

The United States has embarked on a process of comprehensive reform of its personal and corporate income tax system. The United Kingdom recently completed a major reform of its business tax system. Both New Zealand and Australia have moved to reduce the burden of personal income taxes by shifting part of the load onto new consumption taxes. A common concern in all these countries was that high marginal tax rates on both personal and corporate income were causing serious disincentives to work, save, and invest.

The varying approaches to tax reform reflect the particular economic concerns and political pressures of each jurisdiction. This section assesses two recent proposals for reform of the tax and transfer system. One approach, advanced by the province of Quebec, which operates its own personal and corporate income tax system, aims to lower personal and business tax rates and better integrate the tax and transfer system in that province. A second approach, advocated by the Macdonald Commission, would move the personal income tax in the direction of a personal consumption tax, completely overhaul the corporate tax system, and radically restructure the income-security system.

Tax Reform in Quebec

Since the early 1970s, there has been growing public dissatisfaction with the tax system in Quebec. The high level of provincial government spending per capita has meant that Quebec has had to impose heavy taxes. When the federal income tax system was indexed to offset the effects of inflation in 1974, Quebec failed to follow suit. Similarly, when the federal government moved in November 1981 to cut the top marginal tax rate from 63 percent to 50 percent in most provinces, Quebec again did not follow suit.

The Quebec government's ***White Paper on the Personal Tax and Transfer Systems*** estimated that, by 1983, the province was collecting 24 percent more in personal income taxes than it would have under Ontario's income tax system.[5] In addition, marginal tax rates were higher in Quebec for middle- and upper-income individuals than in Ontario and other provinces, raising concerns about Quebec's ability to attract investment and skilled manpower.

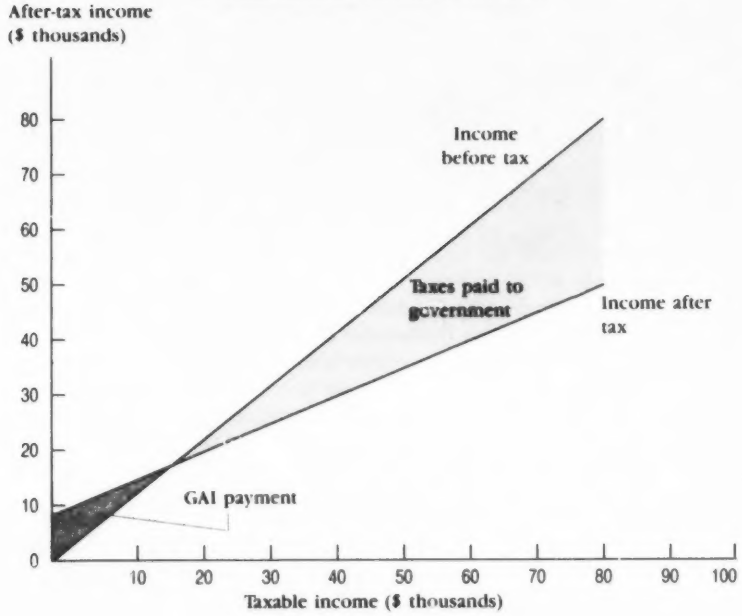
With the 1981–82 recession, another serious problem began to emerge at the lower end of the income scale. The interaction of the tax system and personal transfers — especially social assistance — combined to create very high implicit tax rates for low-income individuals considering returning to work. For single parents, the implicit tax rate on earned income ranged between 75 and 100 percent.[6] The combination of limited employment opportunities in the wake of the recession and these high implicit tax rates created chronic dependence on government assistance and a rising proportion of employable young people living on welfare.

The ***White Paper*** summarizes the consequences of Quebec's fiscal system in the following way:

> The disincentive to work is universal among individuals. At the bottom of the income scale, the protection they receive is so good that

[5] Quebec, Ministère des Finances, *White Paper*, p. 53.
[6] Ibid., p. 146.

Figure 5
A Guaranteed Annual Income



returning to work would place them in a situation where they lost to the government most of the income they earned. Midway up the scale, the magnitude of income tax discourages effort, while at the top, marginal rates which are unequalled in Canada generate continual protest and pressure.[7]

The *White Paper*'s architects viewed it as an initial step in correcting this situation. The predominant thrust of its proposals was to integrate the tax and transfer system to eliminate overlap of social benefits and tax provisions and to reduce marginal tax rates at all income levels. The key elements of the reform proposal were a major consolidation of most provincial assistance into a single guaranteed annual income (GAI) and a significant restructuring of tax exemptions and lowering of tax rates.

As illustrated in Figure 5, the objective of a GAI is to rationalize the

[7]Ibid., p. 11.

system so that each individual is either paying income taxes or receiving transfers, but not both at the same time. In the example shown, a married individual with two children is assumed to receive a guaranteed annual income of $7,500. Under the plan, for every dollar of earned income the GAI payment would be reduced by 50 cents. Therefore, at an income threshold of $15,000, the individual would no longer receive transfer payments and would begin to pay taxes on any additional earned income. Supporters of a GAI believe that it would be more effective in reducing poverty than are existing welfare programs and that, because of its lower implicit tax rate, it would reduce existing disincentives to work.

The specific elements of the Quebec plan are the following:

- *Transfer changes*. Provincial programs such as social aid, the employment-income supplement, child-care allowances, and housing assistance would be replaced with a minimum guaranteed income that would cover recognized essential needs for individuals who are able to work. The rate of reduction of income-guarantee benefits would be 50 percent on each dollar of earned income, compared to 75 to 100 percent under current laws. Additional payments above the guaranteed minimum level would be made to individuals who take part in schooling, retraining, or community work. To reduce work disincentives for young people, the income-guarantee benefits available to young people aged 18 to 20 would take parents' income into account.
- *Tax changes*. An important feature of the proposed reform is the integration of taxes and transfers to ensure that individuals do not receive benefits and pay taxes simultaneously. Under the proposed system, transfers to an individual would decrease gradually as employment income increases; once the transfers have been reduced to zero, the individual would begin to pay taxes. To ensure that this is the case, a lump-sum tax reduction would be introduced to raise the zero-tax threshold for an individual with a dependent spouse to about $16,600 — exactly equal to the income at which transfers are reduced to zero — compared to $11,900 under existing tax laws. There would also be a reworking of personal exemptions to conform to the principle that essential needs should not be taxed. This would include an increase in the spouse's exemption and in the exemptions for children and other dependents. Deductions for child-care expenses and employment expenses would be increased, and a sales-tax credit would be introduced for low-income families to reduce the regressive effect of sales taxes. Finally, a new tax table with reduced marginal tax rates would be introduced to further reduce work disincentives at all income levels.

The *White Paper*'s proposals represent a comprehensive and progressive approach to the reform of Quebec's tax and income-security system. The beneficial effect on the Quebec economy of full implementation of the proposals would be significant.[8] Such reform would create a more positive incentive structure in Quebec, and taxpayers at all income levels would benefit, with the largest proportional benefits flowing to couples with children and individuals with incomes below $15,000. One study of the impact of the reform estimates that, based on reasonable assumptions about the positive effect of lower marginal tax rates on the incentive to work, it could increase employment in the province by 40,000 to 70,000.[9] Over the longer term, the chronic dependence on government assistance and the disincentives to work that accumulated during the 1970s and early 1980s could be reduced.

Quebec began introducing the proposals in its April 1985 provincial budget. It announced its intention to reduce marginal tax rates at the middle- and upper-income levels of the tax table to bring them more closely in line with other provinces. It also increased the married and dependent-children exemptions, as proposed in the *White Paper*. But key proposals, including the consolidation of transfer programs and the lowering of the benefit-reduction rate, as well as full integration of the tax and transfer systems, have not yet been adopted. Plans for full implementation of the proposals will become clearer after the December 1985 provincial election.

The Macdonald Commission's Proposals

Although the Macdonald Commission did not undertake an in-depth review of tax policy, it does focus attention on features of the tax system that unnecessarily detract from long-term economic growth.[10] Furthermore, the Commission proposes a radical restructuring of income-security programs to reduce the disincentive to work that is caused by high implicit marginal tax rates on those who receive income-security benefits.

The fundamental direction for change the Commission proposes has two key elements. The first is gradually to redefine existing personal and corporate income tax bases as personal consumption and corporate cash flow, rather than as income. The second element is to replace of most of the existing structure of social programs with a single program the Commission calls a Universal Income Security Program (UISP).

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[8] Ibid., pp. 299–300.

[9] Fortin and Rousseau, *Economic Evaluation of the Options in the White Paper*, pp. 28–29.

[10] Macdonald Commission, *Report*, vol. 2, p. 206.

Tax Changes

The Commission's recommendations on tax policy reflect its emphasis on the need for the tax system to promote economic efficiency and growth. The Commission is careful to point out that its recommendations are based on a different understanding of the objectives of tax policy than that adopted by the landmark Carter Commission:

> When the Royal Commission on Taxation...reported in 1966, one of the foremost goals of policy analysts was the establishment of a tax system that was equitable in its treatment of different groups. While equity remains an important goal, tax specialists now stress the need for a system that is calculated to encourage economic efficiency.[11]

The Commission expresses concern that the current system of personal and corporate income taxes discourages economic efficiency and growth by reducing saving and investment, by biasing decisions in favor of "safe" investments, and by insufficiently offsetting the distortions caused by inflation.

The avenue for reform the Commission suggests is to move from an income-based to a consumption-based tax system. A personal consumption tax would be calculated on the basis of total income over the year, less the change in registered savings. Moving to a personal consumption tax would involve two changes to the existing system. The first would be to remove current limits and restrictions on registered savings plans, thereby making all savings nontaxable, regardless of how they are invested. The second would be to eliminate exemptions and deductions designed to encourage saving, such as the $1,000 interest-and-dividend deduction and the $1,000 pension-income deduction, which would be made redundant by moving to a consumption base.

The primary advantage of a personal consumption tax is that by exempting all savings from tax, no matter how they are invested, it would eliminate the bias against saving and the distortion of personal investment decisions that the income tax creates. The Commission notes that the often-heard criticism that a consumption tax would be regressive is invalid because both the basic exemption and the rate structure could be altered to achieve whatever degree of progressivity is desired.

In spite of its advantages, shifting to a personal consumption tax would create some concerns about the equity of the tax system. In a study for the Brookings Institution, economists Henry J. Aaron and Harvey Galper argue that a personal consumption tax is not an accurate measure of

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[11] Ibid., p. 206.

a person's ability to pay because it does not take account of accumulations of wealth.[12] This problem could be overcome by adopting a "cash-flow" income tax. Under such a tax, individuals would still be able to exempt their savings from tax, but these savings eventually would be taxed either when they are used to finance consumption or when they are transferred to other people by gift or bequest. It is this taxation of gifts and bequests that distinguishes the cash-flow tax from a consumption tax and relates lifetime taxes more closely to the taxpayer's ability to pay.

The Commission also recommends moving to a cash-flow tax on corporations. The existing tax base for corporate taxes is current revenue less current costs, the cost of depreciation, and interest on debt. Under the cash-flow approach suggested by the Commission, the tax base would be revenues less all input expenses on a cash-flow basis. Thus, capital-investment costs would be deductible, but no deductions would be allowed for depreciation or interest costs. This approach could correct several problems inherent in the existing corporate income tax. By making all capital investment deductible immediately, it would eliminate differences in marginal tax rates on different types of investment and reduce the bias against risky investments; by eliminating deductions for depreciation and interest costs, it would end the distortions in the taxation of capital income caused by inflation; and by adopting a consistent method of defining personal and corporate tax bases, it would permit full integration of personal and corporate income taxes. But moving to a cash-flow corporate tax would represent a major change in the rules — a change that would create its own problems for many companies.

Transfer Changes

The Macdonald Commission concludes that Canada's system of income-security transfers is also badly flawed. An analysis of Canada's existing social policies that provide benefits to the elderly, to families, and to welfare recipients leads the Commission to conclude that a comprehensive reform of the system is required. It criticizes the existing system as ineffective in alleviating poverty, as too complex, as destructive of work incentives, and as inequitable and potentially unsustainable as the population ages.[13]

The Commission concludes that while some progress could be made toward improving the effectiveness of the current system by reforming individual programs, only a comprehensive package would have the scope to address all of its flaws. Consequently, it suggests a comprehensive re-

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[12] H.J. Aaron and H. Galper, *Assessing Tax Reform* (Washington: Brookings Institution, 1985), p. 21.

[13] Macdonald Commission, *Report*, vol. 2, p. 283.

form that would create a UISP to replace the Guaranteed Income Supplement paid to low-income pensioners, the Family Allowance, married and child exemptions, and the child tax credit, as well as federal government contributions to social assistance payments and social housing. A UISP, therefore, would replace much of the present complex range of social programs with one transfer.

The program differs from a GAI, which the Commission argues "connotes a program with a very high level of benefits for those who have no other income and a relatively high reduction rate (effective tax rate) for beneficiaries."[14] Instead, a UISP would offer a relatively low income-guarantee level, with a lower benefit-reduction rate and a special top-up for people who cannot work. This approach, in the Commission's view, has the advantage of providing a more desirable combination of income support and work incentives.

In the illustrative example of UISP favored by the Commission, a family of four would receive a basic income guarantee of $7,000 from the federal government and an additional $3,500 to $4,500 in provincial social-assistance benefits. The federal portion would be subject to a 20 percent benefit-reduction rate, so that for every dollar of income from employment, UISP benefits would be reduced by 20 cents. Thus, the program would reduce significantly the very high implicit marginal tax rates that create disincentives to work under current income-security programs.

Some critics of a UISP will argue that it is not feasible — that for the cost of the program to be acceptable, either the income-guarantee level will have to be too low or the benefit-reduction rate too high. Others will argue that because all proposed reform options reduce the transfer payments flowing to middle- and upper-income families, such a program would not muster the political support necessary to see it implemented. Still others will argue that even a modest income-guarantee level would encourage abuse of the program and require making benefits contingent on active job search or some other form of work-testing.

The Commission is probably somewhat optimistic in its estimates of the income-guarantee level and benefit-reduction rate that could be financed within the cost of existing programs. A higher reduction rate of 25 or 30 percent might be required.[15] But this would still be a major improvement when compared with the 75 to 100 percent rates that apply to some current programs. While recipients might become dependent on a UISP, such dependency probably would be less than occurs under the current system because the recommended lowering of the benefit-

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[14] Ibid., p. 795.

[15] M. Wolfson, "On the Distributional Impacts of a Guaranteed Income for Canada," *Choices* (Institute for Research on Public Policy), September 1985.

reduction rate reduces the disincentive to return to work.

An important shortcoming of the income-security proposal is that there is no discussion of how it is linked with the Commission's recommendation of a personal consumption tax. The Quebec *White Paper* focused attention on integrating the system so that individuals would either receive transfers or pay taxes but not both simultaneously. The Commission's recommendations fail to spell out clearly how basic personal tax exemptions and deductions would be affected by moving to a consumption base and how they would be integrated with a UISP.

Ultimately, the Commission's analysis forces Canadians to recognize some hard truths about social programs. The current system is flawed; piecemeal reforms are unlikely to provide adequate income support or reduce the severe disincentives to work that exist in the current system. But comprehensive reform plans that correct the problems of the existing system mean reduced payments to middle- and upper-income groups.

Taken together, the proposals contained in the Quebec *White Paper* and in the Macdonald *Report* provide a useful framework for thinking about reform of Canada's tax and transfer system. In particular, their comprehensive approach to correcting the flaws of the existing system provides a useful benchmark against which changes to the system can be assessed.

Piecemeal Approaches to Reform

Sweeping changes to the tax system and to social policy cannot be made overnight. Because the issues are complex and the financial impact on individuals and firms potentially large, the wisest political strategy is to introduce change incrementally. Some argue that small changes are desirable, since even well-designed proposals must be able to survive political pressures and compromises to be acceptable in a democracy. But small changes also occur because of lobbying by special-interest groups or because the government is faced with a need for higher revenues.

The changes to the system that the federal government is now considering are motivated partly by a desire to reform the system but also partly by these latter types of pressures. Three of the options under consideration include a minimum personal tax, the replacement of the existing federal sales tax with a broadly based value-added tax, and an overhaul of the corporate income tax.

A Minimum Personal Tax

In its May 1985 budget, the federal government announced that it would introduce a minimum personal income tax to improve the fairness of the

tax system.[16] In doing so, it was responding to pressures to distribute widely the burden of deficit reduction, and public concerns that some high-income individuals take advantage of existing tax provisions to shelter virtually all of their income from tax. The government recognized that it would be politically difficult to raise taxes and reduce transfers to middle-income Canadians while some high-income individuals were paying little or no tax at all.[17]

There are two principle causes for this situation. The first, and most important, is the occurrence of sharp variations in income and in the use of tax credits and deductions from one year to the next. The Department of Finance estimates that, over a period of several years, the number of high-income individuals who pay less than 10 percent in tax is only a small portion of the number observed in a single year.

The second obvious cause is the availability of a wide range of special exemptions, deductions, and tax credits in the personal income tax, as listed in Table 8. In 1982, these tax preferences reduced by $1.4 billion the taxable incomes of individuals with gross incomes over $50,000. About two-thirds of this total was accounted for by four items: the dividend-tax credit, the exclusion of one-half of capital gains, deductions for pension contributions, and deductions for business losses.

In his May 1985 budget speech, the Minister of Finance noted that the incentives in the personal tax system serve valid objectives and that tax planning is a legitimate way to make use of these incentives. If one accepts this, and income volatility, as reasons why some high-income individuals pay little or no tax, then the only motive that can be advanced for the introduction of a minimum tax is a political one: such a tax is necessary if deficit reduction is to garner any public support.

Unfortunately, each of the three options the Department of Finance has outlined for a minimum tax would worsen flaws in the existing personal income tax. Two — the alternative minimum tax and the add-on tax — would add a new layer of complexity to the tax system. The add-on tax, moreover, would collect higher taxes from all individuals who claim tax preferences, not just those with high incomes. Even so, a significant number of high-income individuals would still pay no tax under this option. Each option — including the limit on preferences approach — would raise marginal tax rates for high-income individuals and dimin-

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[16] The Hon. Michael H. Wilson, *Budget Speech* (Ottawa: Department of Finance, May 23, 1985), p. 15.

[17] In a discussion paper released with the budget, the Department of Finance estimated that about 4,000 individuals with incomes over $50,000 paid no income tax in 1982. Another 27,000 individuals in this income category paid less than 10 percent of their income in taxes (Department of Finance, *A Minimum Tax for Canada* [Ottawa, May 1985], p. 6).

Table 8
Sources of Low Taxes for High-Income Individuals, 1982[a]

Tax measure	Reduction of taxable income of high-income individuals ($ millions)	Average amount claimed per person
Investment items		
Deduction equivalent of dividend-tax credit	404	$21,500
Capital-gains exclusion	251	16,100
Carrying charges in excess of investment income	129	30,600
Deduction equivalent of investment-tax credit	72	19,900
Negative net rental income from MURBs	63	14,800
Excess capital loss on private business securities	43	31,700
Drilling fund investment incentives	27	17,500
Film investment incentives	13	10,900
Allowable prior-year business losses	40	43,100
Allowable prior-year capital losses	6	6,600
Business losses		
Current-year business losses	122	23,400
Current-year farming losses	41	18,000
Social policy items		
Registered pension plan contributions (employees only)	7	2,400
RRSP contributions	80	5,600
Charitable donations	38	2,900
Alimony deductions	43	20,100
Medical expenses	26	11,500
Gifts to the Crown	21	65,800

[a]Individuals earning $50,000 and over in adjusted gross income paying average federal tax rates of 10 percent or lower in 1982.

Source: Department of Finance, *A Minimum Tax for Canada* (Ottawa, May 1985), p. 12.

ish their incentive to undertake what the government maintains are worthwhile activities. Finally, none of the options would be expected to raise a large amount of government revenue relative to the size of the deficit — Department of Finance estimates based on reasonable exemptions and tax rates range from $100 million to $250 million in additional revenue.

The Institute has argued that to build public support for deficit reduc-

tion, the government could impose a minimum tax, but only until all personal tax expenditures are evaluated on their effectiveness. Such an evaluation should lead to the phasing out of tax provisions that are no longer warranted and a gradual move toward fundamental reform of the tax system. If the cash-flow income tax described earlier in this chapter were adopted, for example, most of the major tax provisions listed in Table 8 would disappear, as would the need for a minimum personal tax.

A Value-Added Tax

Another option the federal government is studying is the replacement of the existing manufacturers' sales tax (MST) with a value-added tax (VAT) similar to that used in many European countries. A VAT is like a national sales tax that is levied on the value added at each stage of production of all goods and services. Because a VAT would have a more comprehensive base than the existing MST, it would raise significantly more revenue for each percentage point of tax rate.

Pressures for a VAT come from two sources. The first is a general dissatisfaction with the MST on the part of both the federal government and the manufacturers who pay the tax. The MST is costly and complex to administer. The list of exemptions is arbitrary, making the tax difficult to justify, and has eroded the base to the point that the tax creates major distortions by placing a heavy tax burden on a narrow set of manufacturing industries.[18]

The second source of pressure is the government's need to increase its fiscal room to maneuver. Although a VAT might be designed initially to raise only the same amount of revenue as the existing MST, there can be little doubt that the government could use a comprehensive VAT to achieve deficit reduction in the future. The Department of Finance estimates that a comprehensive VAT could generate $2.5 billion for every percentage point of tax. Thus, a 4 percent VAT would generate revenue equal to the current 10 percent MST, while a 6 percent VAT would generate a net increase of $5 billion in federal revenue per year.

Supporters of a VAT argue that replacing the MST with a VAT would reduce the distortions, administrative complexities, and costs of the current system. At present, five commodity groups — motor fuels, vehicles and parts, alcohol and tobacco, construction materials, and furniture — account for 60 percent of MST revenues. The fact that a few commodities bear a disproportionate burden of the tax means that consumption

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[18] For a detailed examination of the defects of the manufacturers' sales tax, see M. Gillis, "Excising Excises: Federal Sales Tax Reform in Canada," in *Report of Proceedings of the Thirty-Sixth Tax Conference* (Toronto: Canadian Tax Foundation, 1985), pp. 460–476.

of the products and investment in the industries that produce them is discouraged. This distortion would be eliminated by a VAT, which would tax the value added at each stage of production of virtually all goods and services. Although there would be transitional costs in implementing a new tax, once in place the cost of collecting a VAT per dollar of tax revenue would be lower than for other kinds of taxes. It is also a difficult tax to evade because of its self-policing nature. Companies at advanced stages of processing have an incentive to make sure their suppliers have paid the tax because they can credit such earlier payments against their own liabilities.

Supporters of a VAT claim that it has additional advantages. Some argue that it would improve the balance of payments by increasing the tax paid on imports and by providing a rebate on exports. Others claim that it would improve the environment for saving and investment by shifting the tax burden toward consumption activities, thereby reducing pressures to raise income taxes.

The pressing need to reduce the federal deficit does not mean that the government should adopt a VAT uncritically. Indeed, there are persuasive arguments against a VAT, despite its revenue-raising potential. First, although there is no constitutional reason why the federal government cannot levy a VAT, the provinces view such broad-based indirect taxes as their domain. A federal-provincial dispute over the matter could result. To avoid such a dispute, the federal government could try to persuade the provinces to replace their retail sales taxes by adopting the federal VAT base and levying their own provincial VAT rate. Second, by itself, a VAT is a regressive tax, meaning that it places a proportionally heavier tax burden on low-income individuals who consume most of their income than on high-income individuals who do not. The regressive nature of the tax could be offset by providing a refundable sales tax credit — as Ontario now does for its retail sales tax — but doing so would further increase the complexity and erode the base of the income tax. Third, even though a VAT would reduce the pressure to raise more revenue through the income tax, it does nothing to correct the serious flaws in the income tax system that were outlined at the beginning of this chapter. Finally, there is a risk that a VAT could provide governments with new revenues and reduce pressures for efficiency in government and reduced government spending. Our review of these arguments and of the evidence suggests to us that a VAT is an effective way to remove the distortions of the MST and is likely to be increasingly attractive if the federal government fails to control spending. Its adoption, however, would detract attention from the more fundamental problems of the tax and transfer system.

The Corporate Income Tax

A third candidate for reform is the federal corporate income tax. Once again, pressures for reform arise not from the recognition of the need for a comprehensive strategy for improving the tax system but from two other sources. The first is the potential need to harmonize Canadian corporate taxation with reforms actively under consideration in the United States. The second is the need to correct what the Department of Finance calls "serious structural problems" in the corporate tax that encourage wasteful and inefficient behavior by Canadian firms and that erode the federal tax base.

A discussion of options for revising the U.S. corporate income tax has been an important element of tax-reform debate in that country during the past year. The U.S. Treasury Department fired the opening shots in the debate with its November 1984 proposals for reform of the personal and corporate income tax systems.[19] President Reagan adopted the general thrust of these recommendations — lower tax rates and a broader and simpler tax base — in his May 1985 tax-reform proposals. In late 1985, congressional tax-writing committees were attempting to draft a tax bill that could meet the president's basic objectives and forge a consensus in Congress. If enacted, the proposals would reduce statutory tax rates on both personal and corporate income and offset the resulting revenue loss by reducing or eliminating many special tax provisions.

The top corporate tax rate would be reduced to 33 percent from 46 percent under both the Treasury and Reagan proposals. Measures that would alter the corporate tax base include:

- elimination of accelerated depreciation allowances: instead, allowances would reflect more closely actual depreciation;
- introduction of comprehensive indexation: interest income and expenses would be adjusted to approximate the portion that reflects real income or expense; capital gains, inventory costs, and depreciation charges would all be adjusted for inflation;
- reduction or elimination of many special provisions, such as those for the oil and gas industry.

The proposed changes to corporate taxation in the United States have sparked heated debate. Everyone agrees that they would raise government revenues by approximately 20 percent and help finance a reduction in revenue resulting from reform of the personal income tax. Proponents

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[19] United States, Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth* (Washington, D.C.: U.S. Government Printing Office, 1984).

argue, however, that the changes would also encourage efficiency and growth. Lower marginal corporate tax rates and full inflation indexation could enhance the incentive to invest, while the elimination of fast writeoffs and investment-tax credits would reduce the variability of effective tax rates across industries. Critics argue, however, that the proposed changes would have a negative impact on private investment.

Under current U.S. law, the effective corporate tax rate is much lower for equipment than for industrial structures. The proposed tax changes would raise the effective tax rate on equipment and lower it on structures, a result that would produce more uniform effective tax rates across industries and lead to a more efficient allocation of capital.

Proponents of the reform say that it would favor emerging services-sector industries and high-technology companies that currently face high effective tax rates. But critics argue that many industries, including those that benefited most from accelerated depreciation and other business-tax changes implemented during President Reagan's first term in office, would face higher effective tax rates on investment. They further maintain that powerful incentives to invest in business equipment are needed to improve productivity and competitiveness. According to Martin Feldstein, former chairman of the president's Council of Economic Advisers,

> capital that now goes into equipment will be diverted into office buildings, shopping centers, housing and other types of investment that do not have the same favorable effects on employee productivity. More generally, an increase in the overall cost of capital would cause some funds to be diverted abroad in pursuit of higher after-tax returns. American industry would lose the productivity-increasing equipment needed to remain competitive in many high-technology world markets.[20]

No matter what corporate tax reform the United States ultimately adopts, the uncertainty generated by the reform process probably is already hurting U.S. investment. Investment projects that rely upon accelerated depreciation or the investment-tax credit for their viability have already been postponed.[21] Many corporate treasurers now are reluctant to advocate continuation of capital-spending plans because they cannot compute the effect of possible tax changes.

In Canada, attention has focused on a similar need to reform the cor-

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[20] M. Feldstein, "A Flawed but Fixable Tax Plan", *Wall Street Journal*, July 19, 1985, p. 20.

[21] A. Murray, "Reagan Tax Proposal Already Brings a Halt to Some Investment," *Wall Street Journal*, June 19, 1985, p. 1.

porate tax system. In a discussion paper, the Department of Finance demonstrates that accelerated depreciation and the investment-tax credit create an uneven pattern of effective tax rates across industries and regions, as shown in Table 9.[22]

A more serious structural problem in the Canadian corporate income tax, according to the department, is the accumulation of large pools of unused deductions and tax credits by some companies, as shown in Table 10. Companies that report a profit can reduce their taxes by claiming deductions for previous years' business losses, accelerated writeoffs, or investment-tax credits. Some companies that have experienced large business losses or that have large capital-expenditure programs have built up large reserves of unused deductions or credits — the department estimates these had a value of $13.8 billion in 1981 and they have certainly increased since then.[23]

There are two important consequences of this accumulation of unused tax deductions and credits. The first is that for many companies, these deductions and credits represent corporate savings that cannot be mobilized to finance investment. Because such companies are rarely taxable, they are little influenced by the introduction of new tax incentives to encourage investment. Furthermore, existing restrictions on the ability of nontaxpaying firms to transfer their credits and losses to taxpaying firms means that the former are prevented from improving their balance sheets. Some tax specialists argue that because of existing restrictions on loss transfers, Canada's corporate tax system is not internationally competitive, particularly in relation to the United States.[24]

The second important consequence of this large pool of unused tax benefits is the incentive it creates for business takeovers that transfer unused tax benefits to taxable corporations. To prevent large reductions in corporate tax revenue, the federal government has introduced complex new restrictions on leasing arrangements, limited partnerships, and other methods of transferring unused credits and losses. This situation has created instability and uncertainty in the corporate tax system, failed to resolve the loss-transfer problem, and encouraged takeovers motivated entirely by tax considerations.

The Department of Finance's proposals for reform of the corporate tax stop short of the Macdonald Commission's bold endorsement of a cash-flow corporate tax that would eliminate the need for accelerated depreci-

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[22] Department of Finance, *The Corporate Income Tax*, pp. 10–16.

[23] Ibid., p. 18.

[24] See G.E. Cronkwright, "A Proposed System of Transfers of Deductions, Credits and Losses within Corporate Groups"; and W.A. Macdonald, "Non-Tax Considerations in Transfers of Deductions, Credits and Losses within Corporate Groups," in *Report of Proceedings of the Thirty-Sixth Tax Conference*, pp. 755–782.

Table 9
Marginal Federal and Provincial Corporate Tax Rates by Sector and Province[a]
(percentage)

	Agriculture, fishing, forestry	Manufacturing	Construction	Transport	Wholesale trade	Retail trade	Services	*Total*
Newfoundland	-7.4%	13.5%	17.2%	34.1%	27.4%	28.8%	23.5%	*26.6%*
Prince Edward Island	-1.2	8.4	14.1	28.8	23.3	25.5	20.3	*14.1*
Nova Scotia	-3.3	12.6	16.6	33.3	26.7	28.2	22.9	*24.1*
New Brunswick	-5.7	11.0	12.6	32.9	24.0	24.9	19.2	*23.5*
Quebec	2.1	11.0	13.1	25.5	20.5	21.0	17.4	*17.1*
Ontario	5.3	18.6	17.7	33.8	26.5	25.3	21.9	*22.9*
Manitoba	7.6	19.7	20.8	34.8	29.2	29.1	25.5	*26.7*
Saskatchewan	7.6	18.4	20.8	24.8	29.2	29.1	25.5	*23.0*
Alberta	6.3	17.0	17.4	30.3	25.0	24.6	21.5	*23.1*
British Columbia	7.3	21.2	21.0	34.9	29.2	28.5	25.3	*28.2*
Canadian average	*4.0*	*16.6*	*17.0*	*31.7*	*25.3*	*25.0*	*21.4*	*22.4*

[a]Combined marginal tax rates for large and small businesses.

Source: Department of Finance, *The Corporate Income Tax System: A Direction for Change* (Ottawa, May 1985), p. 16.

Table 10
Tax Position of Corporations, 1981

	Taxpaying	Nontaxpaying			
		Profitable	Not profitable	Total	*Total*
		(thousands)			
Number of corporations	208	141	163	304	*512*
		($ billions)			
Tax value of unused deductions and tax credits	0.0	7.4	6.4	13.8	*13.8*
Investment	20.0	19.0	11.0	30.0	*50.0*

Source: Department of Finance, *The Corporate Income Tax System: A Direction for Change* (Ottawa, May 1985), p. 17.

ation, investment-tax credits, and inflation adjustment by simply allowing business investment expense to be written off immediately. Instead, not surprisingly, they are similar to those advanced in the United States. They call for reducing the statutory tax rates to 36 percent from 46 percent for all corporations, accompanied by eliminating the investment-tax credit and reducing rapid writeoff rates for most types of investment. Unlike the U.S. proposals, which would raise corporate tax revenue by about 20 percent, the department's proposals are designed to leave the level of corporate tax revenues unchanged.

A second element of the department's approach is a proposal that would allow the transfer of business losses within a commonly owned group of companies, a measure that would promote corporate restructuring and increased private investment.[25] In doing so, it would accord Canadian companies similar treatment to that already in place in the United States and the United Kingdom.

Of the three tax-reform options the federal government is considering, the corporate-tax proposal is the most capable of reducing some of the distortions inherent in the existing tax system. Yet, it too is primarily an attempt to respond to the external pressures of U.S. tax reform and to the internal instability of the existing system. The proposal to reduce the rate and broaden the base of the corporate tax is subject to the same concerns as the U.S. proposals: first, that it will discourage aggregate invest-

[25] Department of Finance, *A Corporate Loss Transfer System for Canada* (Ottawa, May 1985).

ment by introducing new uncertainty and, second, that it will reduce investment in equipment at a time when Canada, more than most countries, is challenged to improve its productivity and international competitiveness.

Conclusion

Gradual reform of Canada's tax and transfer system could help meet the strategic objectives of encouraging initiative and growth, and could help bring the federal budget deficit under control. The current system creates wasteful distortions in economic behavior that act as an obstacle to growth. Comprehensive reform could reduce or eliminate the worst flaws in the system. The problem with comprehensive reform is the notion that "you can't get there from here!" Quebec is moving in the right direction with the recommendations in its *White Paper*. Much remains to be done, however, to achieve the full integration of taxes and transfers.

The piecemeal changes the federal government is considering, on the other hand, are not the result of a comprehensive strategy to reduce distortions and other problems created by the existing system. Instead, the proposals arise from political pressures, administrative problems, and lack of revenues. Shifting the tax burden toward consumption by relying on a well-designed value-added tax and adopting a more internationally competitive corporate loss-transfer system could help mobilize Canadian savings for investment and growth. But the federal proposals would do nothing to integrate the tax and transfer system to reduce the disincentive to work; they would add to the complexity of the personal tax system; and they would provide the government with a potentially rich, value-added tax that could reduce pressures to restrain government spending.

But Canadians still have a choice. They can accept the federal proposals that respond to the political and financial pressures the government faces. Our assessment of the problems with the system suggests to us, however, that a more comprehensive strategy for reform of the tax and transfer system is required. Most other industrial countries are further along the path to comprehensive reform. But Quebec's *White Paper* and the Macdonald Commission *Report* have provided important new building blocks in 1985. To ignore them would be very short-sighted indeed. What is required next is determination by governments to move incrementally toward a system that promotes strategic objectives of stronger private investment and growth and, at the same time, that reduces the complexity and perceived unfairness of the current system.

5

Reorienting the Canadian Economy

The challenge Canadian policymakers face in the next few years is to keep in clear view the goal of economic adjustment. The status quo cannot be a goal of economic policy if Canadian living standards are to continue to rise in future.

Change does not happen with a Big Bang. It is an ongoing process in the economy, pushed along by the winds of competition. Vested interests try to shelter themselves from these winds; the wise harness them to move forward. If government lacks a strategic view of the overall direction in which the economy must move, it can easily be swayed by those seeking shelter to confuse narrow interests with the expression of the national will.

This *Policy Review and Outlook* has focused on three policy problems for which solutions that serve Canada's long-term interests involve tough decisions by governments:

- A trade policy that is no longer sustainable in a turbulent and increasingly competitive world. Canada is the only major industrial nation, other than Australia, that does not have secure access to a market of 100 million people. The dangers of U.S. and European protectionism are greater than they have been since World War II. Loss of access through any of the many measures outlined in Chapter 3 would create a major economic crisis in Canada. Threats of protectionist measures that exist in the status quo are increasing Canada's vulnerability and reducing policy independence.
- Accumulating federal debt that requires an increasing proportion of annual revenues to service, and an annual deficit that, if nothing else changes, will remain in the $25–35 billion range throughout the decade even under favorable economic conditions.
- A tax and transfer system that is seriously distorting decisions about work and investment. Yet, tax rates are being raised to reduce the federal deficit, thereby adding to distortions.

Those who might argue against this definition of the problems or against the tough policy changes required to correct them seem implicitly to give the economy far less credit for its ability to change and adjust than they should. As the evidence in Chapter 2 illustrates, dynamic change is always occurring; employment in some industries shrinks while it grows in others. The crucial lesson to be learned is that change is inevitable.

The wrong policies will bring about harmful change. The challenge is to adopt policies to ensure that realistic information about Canada's future economic prospects is driving internal economic change.

The targets for policy in 1986 should, above all, be ones that reflect hard economic reality. They include:

- a tax and transfer system that promotes adjustment;
- an internationally competitive industrial sector;
- an efficient and flexible private sector;
- an efficient public sector; and
- secure access to the large U.S. market.

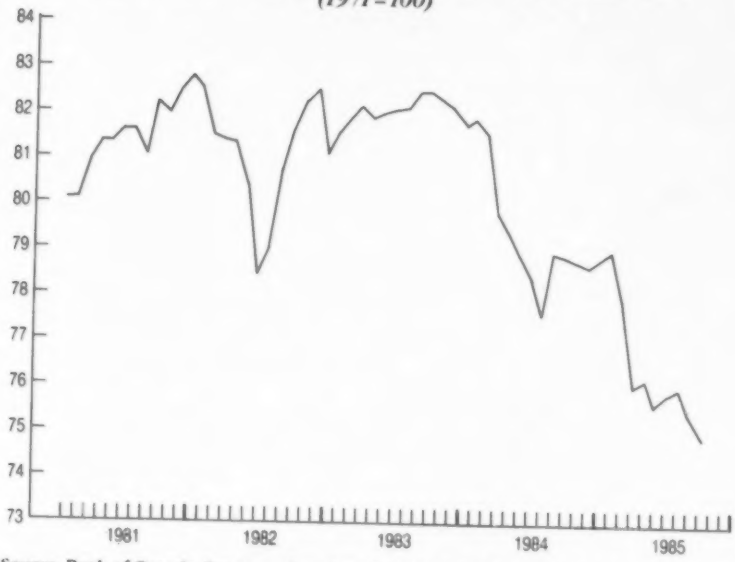
Achievement of these targets will mean success in creating faster noninflationary growth in investment and jobs.

But policymakers also face important constraints in solving these problems. They face the challenge of balancing toughness in adopting policy changes with fairness in spreading the burden of adjustment, and the challenge of achieving economic change without compromising political and cultural independence.

One of the most important constraints they face is posed by uncertainty about the international economic environment. A key question is whether the international environment will be as favorable in 1986 as it was in 1985 for reorienting Canadian economic strategy. Reasons exist for optimism. U.S. interest rates and the value of the dollar have dropped significantly. Energy prices are continuing to decline in real terms, especially in Europe, where the depreciation of the U.S. dollar adds to the drop in the dollar-denominated price of oil. This combination of lower interest rates and lower oil prices will provide for stronger growth in the industrial countries in 1986. The U.S. economy was already showing signs of a pick-up in growth by late 1985, improving the prospects for sustaining growth in the 2–3 percent range in 1986. Some strengthening in Europe's economic performance can also be expected in 1986 as domestic demand and investment opportunities improve and real energy prices drop. Growth in Japan will remain among the best in the industrial countries in spite of the rise in value of the yen and efforts to open the Japanese domestic market to foreign imports.

But certain risks in the outlook are so great that, if they were to materialize, the world economy could be thrown into a serious recession. U.S. economic policy is a central factor — contributing to serious imbalances in the international trade and financial systems. If the U.S. budget deficit continues at its current annual level of U.S.$200 billion, federal borrowing requirements also will remain at high levels, thus maintaining pressure on interest rates and the U.S. dollar and, therefore, continuing the

Figure 6
Canadian Dollar Index Against Group-of-10 Currencies, January 1981–September 1985
(1971=100)



Source: Bank of Canada. For an explanation of the Group-of-10 currencies, see "Technical Note: A Weighted-Average Exchange Rate Index for the Canadian Dollar," *Bank of Canada Review*, September 1984, pp. 19–24.

danger of U.S. protectionism. Even if the U.S. dollar continues to depreciate, the U.S. current account deficit will remain high and may even continue to rise in 1986. If any of the several broad-ranging protectionist bills before Congress are legislated, the possibilities of trade retaliation and a negative reaction by heavily indebted countries are great. The problem of international indebtedness continues to be extremely serious, most recently because of Mexico's troubles, but also because of unexpected persistent weakness in commodity prices. None of these problems can be handled by any one country. They underline the importance of global interdependence. Canada's prospects now depend on what happens in Mexico and Brazil as well as in the United States.

Canadian policymakers will be well advised to take these uncertainties into account. But the impact of adverse developments — which could well continue to be risks for the rest of the decade — could be even more

serious if policy does *not* change to facilitate adjustment. Policy action should occur because, international uncertainty aside, Canada's short-term prospects are good. Lower Canadian interest rates will help sustain a revival in business investment and residential construction that is already under way. Stable inflation performance and the continuing decline of the trade-weighted value of the Canadian dollar, shown in Figure 6, are gradually improving Canada's competitiveness in world markets. These factors, along with possibly lower world oil prices, should bolster business and consumer confidence and maintain growth of real output and employment at a rate sufficient to continue the slow decline of unemployment. But achieving more balanced growth in industries and regions and making that growth sustainable will require continuing change in economic policy.

Canadian-U.S. Trade Negotiations

Canada's trade initiative had received little attention from the United States by the end of 1985. But the issues are likely to be scrutinized closely in 1986. Government agencies and congressional committees will hold public hearings. Negotiators on both sides of the border will establish their objectives, draw up their lists of key negotiating issues, and establish their bargaining strategies.

Negotiating Objectives

Canada's objectives have been officially stated only as achievement of more secure and enhanced access to the U.S. market by enshrining a better set of rules for the conduct of bilateral trade.[1] But since another objective of equal importance is to ensure the bilateral negotiations are compatible with Canada's obligations under the General Agreement on Tariffs and Trade (GATT), it is likely that Canada will pursue a free-trade area that is acceptable to the GATT under Article XXIV. Canada's most important objective — that of secure access to the U.S. market — will require agreement by the United States on a formula for halting the unpredictable and damaging application of nontariff barriers. In its recent negotiations with Israel, the United States refused to accept such restraints. So, at the end of 1985, it appears that an agreement on this issue would be the toughest to negotiate. Without such an agreement, however, it is difficult for us to see how Canada could accept a bilateral trade arrangement.

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[1] The Hon. J. Kelleher, Report to the Rt. Hon. Brian Mulroney, Ottawa, September 26, 1985, p. 2.

Two aspects of possible U.S. negotiating objectives suggest that success might be possible. First, a bilateral free-trade agreement could serve broader strategic objectives by demonstrating that the world trading system, in some areas, will remain open. Second, a compromise is possible. This could be, for example, a formula that applies countervail to the differential between subsidies available to firms in the two countries.

Exclusions

Many Canadians are understandably concerned about what is "on the table" in the bilateral negotiations. Differences in national history and philosophy, in geography, and in population size contribute to Canadian nervousness about U.S. intentions in the trade negotiations. For these reasons, negotiators would be well advised to hold exploratory discussions to identify and separate policies expressly intended to distort trade in goods and services from those that may affect bilateral trade but only as an unintended side effect of differences in the way the two countries have evolved.

In this context, misperceptions about social and cultural policies that express Canada's unique character can be dealt with. Generally available social policies such as unemployment insurance and government funding of health care, as well as policies that promote Canadian culture while not distorting trade and investment flows, should be clearly defined and ruled nonnegotiable on both sides.

Exploratory discussions should also deal with the question of whether sectors with unique circumstances, such as agriculture and automobiles, should be included in the negotiations. In automobiles, Canada and the United States already enjoy tariff-free access to one another's markets under the auto pact. Because the current arrangement serves both countries' interests reasonably well, neither country appears to be inclined to include the auto pact in the negotiations. In agriculture, both countries have complicated farm programs that distort trade patterns in some commodities. The complexity of these programs, as well as the need to move slowly to prevent serious disruptions within the agricultural sector, makes it unlikely that this sector's inclusion would be an essential component of an agreement.

Negotiating Issues

Canada's negotiating objectives will have to be ranked in importance. We have identified those that are likely to top the list. In order to achieve them, however, Canada will have to identify others where it might be willing to compromise. To achieve its objective of limiting future U.S. use of countervailing duties, for example, Canada probably will have to be

prepared to respond to U.S. concerns about the retroactive application of regulations, particularly on foreign investment activity, and to examine its practices with respect to industrial subsidies and government procurement.

The question Canadian negotiators should ask about each of the changes the United States will seek is: "Does this policy serve the national interest, or does it benefit special interests at a net cost to all Canadians?" If the policy in question cannot meet the test of serving the national interest, Canada should be prepared to negotiate changes in return for improved access to U.S. markets. For example, Canada should take a hard look at the "concessions" that the United States is likely to seek. Many of the changes, including reduced use of industrial subsidies, further easing of restrictions on U.S. investment in Canada, national treatment of U.S. firms in Canadian government procurement, freer trade in services industries through reduced regulation and an easing of entry restrictions, are likely to benefit Canada in the long term. Many of them have been recommended as worthwhile policy changes even if Canada is unable to negotiate a free-trade area with the United States.

Adjustment

It is sometimes assumed, quite erroneously, that a successfully negotiated free-trade area would be implemented the next day. The reality, of course, is that such an agreement would be phased in over a period of time. This phase-in, it can be argued, should be longer for Canada because of the proportionately larger adjustments Canadians will have to make. At the end of that time, changes will be under way in the structure of Canadian industry. The analysis in Chapter 2 indicates that the restructuring that would be associated with freer trade would be accomplished primarily by redirecting business startups into industries where Canadian firms can be competitive, not by wiping out whole industries. Some of the industries that rely on protective tariff and nontariff measures will become more specialized in areas in which they can remain competitive. Other industries, such as resource-processing, that now are penalized by tariffs will benefit from the agreement. Still other industries, mainly in manufacturing, will benefit from new opportunities to increase economies of scale and raise productivity. The problem in predicting where production will be expanded, however, is that opportunities will only become apparent as producers intensively examine prospects for product niches in the months and years ahead. In the short time that bilateral freer trade has been a possibility, producers have been quicker to identify the weak parts of their operations that might be closed than the investments and jobs that will be created.

There seems little question that governments in Canada will have to

attach considerable importance to assisting individuals who are displaced by firms that rationalize operations in response to the phasing-out of tariffs. The Macdonald Commission has led the way by proposing the creation of a Transitional Adjustment Assistance Program (TAAP). In addition, governments should examine the idea of making severance payments tax exempt, as is the U.K. practice, to assist individuals to adjust. These concerns link closely with the second policy priority: reducing the federal deficit.

The Federal Deficit

A unique opportunity is likely to exist in 1986 to make substantial progress toward reducing the deficit to sustainable levels. Yet at the end of 1985, it seems entirely plausible that the status quo will persist in 1986.

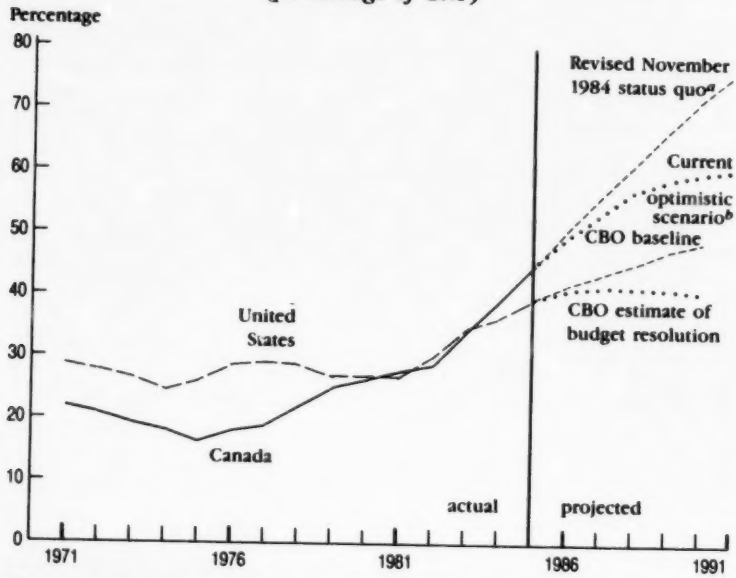
The danger that persists is posed by continued debt accumulation. If no action had been taken since November 1984 to reduce the size of annual deficits, federal debt would have continued to accumulate at an average annual rate of more than 20 percent. Debt-servicing charges alone would have consumed 50 cents out of every revenue dollar by 1990.

What Has Been Achieved

Budget actions taken in 1984 and 1985 delayed a potential fiscal crisis. As things stand at the end of 1985, annual deficits are likely to remain in the $25–35 billion range instead of climbing to $50 billion. This is progress, but it is insufficient for two reasons. The first is that the targets for reduction were too small. Federal debt is growing much faster than GNP — a rough measure of the economy's capacity to generate the revenue needed to service the debt. As shown in Figure 7, last year's deficit-reduction measures were sufficient to slow the rate at which the debt was accumulating. Even under the Department of Finance's most optimistic economic scenario, however, debt would continue to grow faster than the capacity of the economy. Only at the end of the decade is it likely to slow to the same rate as the economy is growing. But by then it will be 60 percent of GNP. The severity of Canada's debt problem can be seen when compared with that of the United States. If the U.S. deficit is reduced as the Congressional Budget Office has projected, Canada's debt-to-GNP ratio will diverge sharply from the U.S. pattern.

A reduction in the U.S. deficit would help bring real interest rates down from their historically high level of the last four years. A failure to deal with Canada's deficit and debt problem when the United States is making progress would weaken confidence in Canadian economic policy. The risk is that diminished confidence would put downward pressure on the Canadian dollar and upward pressure on Canadian interest rates, thereby

Figure 7
Debt-to-GNP Ratios, Canada and the United States, 1971–91
(percentage of GNP)



[a]Status-quo projection made by Department of Finance in November 1984, revised to incorporate less-optimistic "mid-range" scenario presented in May 1985.

[b]Based on Department of Finance "favourable" economic scenario presented in May 1985 and adjusted to take account of June 1985 pension decision and to exclude reduction in provincial transfers.

Sources: U.S. Congress, Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1986–1990* (Washington, D.C., February 1985), p. 160; idem, *The Economic and Budget Outlook: An Update* (Washington D.C., August 1985), pp. xxiii, xxiv; and *C.D. Howe Institute Commentary*, September 1985, p. 6.

limiting Canada's ability to take full advantage of the decline in U.S. real interest rates.

As long as Canada's debt problem continues to grow, the risk remains that fiscal policy will be hostage to interest rates. Any adversity that raises interest rates will increase debt-servicing costs and reduce the federal government's room to maneuver. Large public-borrowing requirements will continue to prevent the Bank of Canada from lowering interest rates as much as it otherwise might — the desirable change in the "policy mix"

that could encourage stronger growth and investment is delayed.

The second reason that action to date to reduce the deficit has been insufficient is that the instruments chosen to achieve the reduction are not equal to the task. On the expenditure side, the government has taken measures to improve management in the public sector, to reduce industrial subsidies, and to restrain spending growth in areas such as foreign aid and some social programs. It has raised revenues by imposing user fees on some public services, by reducing inflation indexation of personal income taxes, by introducing temporary tax surcharges, and by broadening the base and raising the rate of the federal sales tax.

These deficit-reduction instruments are not yet equal to a lasting solution to the problem because they do not address the built-in structural imbalance between revenues and expenditures. On the expenditure side, major spending categories continue to grow according to formulae that link per capita spending to inflation, not to the economy's ability to pay for such increases. As a result, resources are being channeled, possibly unnecessarily, into inflation protection instead of into new productive capacity. Another structural factor contributing to continued spending growth is that the population is aging, thus increasing spending on pensions and health care.

On the revenue side, temporary surtaxes also fail to provide a lasting solution. If these surtaxes are removed in fiscal 1987 as planned, the deficit is likely to increase again. Exemptions, deductions, and special tax preferences have eroded federal tax bases. Reducing the deficit by raising tax rates has become a counterproductive exercise because it discourages investment, growth, and efficiency. A lasting solution will require a review of the tax system.

The Problem that Remains

The deficit cuts that have been made rely heavily on tax increases — direct and indirect tax increases for corporations and individuals, and increases that will result from reduced inflation indexation. Relying on tax increases in this way means that the savings generated by the private sector will not be directed into private investment as they would if deficit reduction were focused more heavily on cutting spending. Tax increases represent an increased transfer to the public sector; if this income were used instead for investment activities that would create new productive capacity, it would move the economy toward its full productive potential. But a review of the expenditure pattern under current budget projections suggests such is not the case. Table 11 shows how the pattern of spending is becoming increasingly skewed. Social-program spending will account for more than 63 percent of federal outlays — excluding debt charges — by the end of the decade, compared with 53 percent ten years

Table 11
Federal Expenditures by Major Policy Area, fiscal years 1981–91

Policy area	1980–81		1986–87		1990–91	
	$ billions	%	$ billions	%	$ billions	%
Economic development	8.9	18.6	9.9	12.2	7.7	8.3
Social development	25.3	52.8	47.0	58.0	58.4	63.1
Defense and foreign affairs	6.7	13.9	12.7	15.7	15.9	17.2
Other	7.0	14.6	11.5	14.2	10.6	11.4
Total	*47.9*	*100.0*	*81.1*	*100.0*	*92.6*	*100.0*

Sources: Department of Finance, *Economic Review* (Ottawa, April 1984), p. 184; idem, *The Fiscal Plan* (Ottawa, May 1985), p. 26; and estimates for 1990–91 by the C.D. Howe Institute.

earlier. This shift means that an increasing proportion of federal spending is being directed toward programs that, under existing legislation, will continue to grow faster than the economy's ability to pay for them.

Recommendations

The target: The Institute continues to attach considerable importance to a credible deficit-reduction strategy. The objective of this strategy should be to begin to ***reduce*** the debt-to-GNP ratio by 1990 rather than allowing it to increase or even stabilize as the Department of Finance's 1985 scenarios suggested. With federal debt in the range of $350–400 billion by the end of 1990 and GNP growing at an average annual rate of approximately 7 percent, beginning a meaningful reduction of the debt-to-GNP ratio would require reducing annual deficits to the $15–20 billion range (instead of $25–35 billion). Our estimates, based on Department of Finance projections, are that to achieve this target, at least $10 billion in additional deficit cuts will be required by 1990.

In the Institute's view, measures to cut the deficit should be pursued forcefully at times when economic activity and employment are expected to be growing. Not enough has been accomplished in 1985. The favorable economic prospects for 1986 mean that the federal government again has an excellent opportunity to tackle the deficit.

The instruments: The instruments of further deficit reduction are important. More needs to be done on the spending side of the budget. The Institute has recommended a series of measures to do the job.[2] Some have

[2] See E.A. Carmichael, *Tackling the Federal Deficit*, Observation no. 26 (Toronto: C.D. Howe Institute, 1984); and E.A. Carmichael and W. Dobson, "The Federal Budget: All Things to All People?" *C.D. Howe Institute Commentary*, April 1985.

been adopted, others are still under consideration. Our recommendations for action in 1986 now focus on the latter, and the criteria on which we base these recommendations are twofold. First, the changes should increase the efficiency with which program objectives are achieved. Second, they should facilitate, not obstruct, adjustment to economic change. We recommend:

- moving forward to 1986 the reduction in transfers to the provinces. The federal government had proposed in May 1985 to begin reducing transfers later in the decade, which would have amounted to $2 billion in 1990–91. The government should also consult with the provinces and other interested parties on making changes that could introduce competitive forces into the delivery of health and education services, thereby slowing the future growth of costs. Allowing competition among health-maintenance organizations, fee-for-service systems, and hospital-based facilities could increase Canadians' choices for health care and encourage efficiency and cost control. A change in the financing of post-secondary education by replacing federal grants to the provinces with direct grants or tax credits to students and decontrolling tuition fees at colleges and universities would also encourage competition and make the system more responsive to changing educational requirements;
- implementing the recommendations of the Ministerial Task Force on Program Review, which could involve reducing growth in the federal public service by eliminating programs that no longer meet government objectives;
- further cutting firm-specific industrial subsidies. The government spends approximately $1 billion per year on direct assistance programs to Canadian business. While the government has already taken steps to reduce spending on industrial subsidies, further cuts are possible by sharply curtailing new subsidy commitments. Such cuts would not only help reduce the deficit, they would also improve Canada's bargaining position in bilateral negotiations on the application of countervailing duties by the United States;
- reforming the unemployment insurance (UI) program to reduce disincentives to work and to remove incentives to unstable or seasonal employment that exist in the current program. Adoption of an adjustment assistance program, financed from savings from UI reform, would help reduce the long-term cost of UI by helping to reduce structural unemployment; and,
- reviewing tax expenditures — the government's term for special provisions and incentives built into the tax system — to ensure that they continue to serve appropriate objectives efficiently. Some tax expenditures that were introduced to provide protection against unanticipated increases

in inflation — such as the $1,000 interest and dividend deduction in the personal income tax and the 3 percent inventory-allowance deduction in the corporate tax — are candidates for such a review. These two provisions reduced federal revenues by $1.3 billion in 1983.

While these measures would help meet short-term deficit-reduction objectives, a more comprehensive approach will be required to correct the structural imbalance built into the expenditure and revenue system. Fundamental changes that improve the efficiency of Canada's income-security system — including pensions and child benefits — as well as incremental reform of the tax and transfer system will be required if Canadians want to achieve both lower deficits and lower tax rates.

Reform of the Tax and Transfer System

The existing tax and transfer system is badly flawed. We recommend that a more comprehensive approach to reform be adopted in 1986. Fundamental reform, however, will take time. Making incremental changes in the existing system is probably the only politically viable route. Such changes — based on a strategic view of how the tax and transfer system can promote growth and efficiency — should begin.

In the 1986 budget, the federal government is expected to introduce legislation for a minimum personal tax. It may also unveil plans for reform of the corporate income tax and for the introduction of a value-added tax (VAT). We are concerned that Canadians will end up having little choice in the kind of tax reform they get because few constructive alternatives have been considered at the federal level.

In our view, the Macdonald Commission's skeletal tax-reform proposals and its recommendation of a Universal Income Security Program together could provide a comprehensive framework for improving the existing system and an alternative to the proposals currently under consideration. The advantage of this more comprehensive approach is twofold. First, it would improve the functioning of the economy by removing existing disincentives to work and invest. Second, it would help remove the structural imbalance in federal finances by reducing dependency on government social programs and by broadening the tax base.

If Canadians are unwilling to pursue such a fundamental restructuring of income-security programs and the tax system, then other alternatives, such as a VAT, may become necessary. A VAT would have the advantage of spreading the burden of deficit reduction widely without worsening the distortions in the existing tax system, as occurs when marginal tax rates are increased. Many European countries have adopted a VAT as a broadly based revenue source to finance their growing social policy expenditures.

Meeting the Challenge

These are our policy priorities for 1986: continued pursuit of a new trade agreement with the United States, additional efforts to reduce the federal deficit, and a new approach to reforming the tax and transfer system. In choosing them, our objective is to enhance the economy's ability to adjust to change. But policy recommendations, by themselves, are not enough. Moving beyond the status quo requires that the principal actors in the policymaking process turn recommendations into actions.

The federal government has consulted Canadians extensively. Having listened, it now must decide, on the basis of the national interest, what to do. One decision, with which the Institute agrees, has been to initiate trade negotiations with the United States. Now the federal government must become a shrewd and tough negotiator in pursuing Canada's economic objectives while preserving and enhancing cultural integrity and political sovereignty. It should approach the bargaining table with confidence, a clear set of objectives, and a realistic assessment of what will be required to achieve them.

Provincial governments inevitably will find that liberalizing Canadian-U.S. trade and reducing the federal budget deficit will require them to trade off some particular provincial interest for that of the nation. To achieve a trade deal with the United States, many provinces will have to reduce interprovincial trade barriers, including preferential-procurement arrangements with local firms and special subsidies to encourage economic development. To reduce the federal deficit, the provinces will have to adjust to some changes in federal-provincial fiscal arrangements. Reduced federal transfers to the provinces, however, will be partially offset by federal tax changes that also increase provincial tax revenues.

Business may have to give up some protection and subsidies that have slowed the adjustment process in the past. With improvements in the quality of management, entrepreneurship, and innovation, the required adjustments should occur. Progress will be assisted by government putting in place a policy framework conducive to increased efficiency and growth, by business schools providing more appropriate training, and by shareholders' pressure for such improvements. But government's task is often made more difficult by individual firms or industries seeking to perpetuate a status quo that shields them from foreign and domestic competition.

Business groups such as the Business Council on National Issues, the Canadian Manufacturers' Association, the Canadian Federation of Independent Business, and others have taken on a more influential role in

policymaking in recent years. These groups normally present a business perspective on national issues, rather than a national perspective on business issues. But the issues on the policy agenda in 1986 make it critical that business groups adopt a national perspective. Inevitably, there will be winners and losers from such policy changes as free trade with the United States and reform of the corporate income tax. The important role that business groups can play in national policy debates is to monitor the often-divergent views of their members and to communicate to policymakers the views of those who will win and those who will lose from such changes. Without this kind of input, trade negotiators and policymakers will find it difficult to assess the tradeoffs they are being asked to make.

Labor unions have voiced support of social and economic change, but they have also helped to block change that they view as not being in their members' interests. The policy agenda for 1986 discussed here has important implications for all Canadians, including those in the labor movement. The status quo is not a viable option, but alternatives can be shaped, for example, through consultative groups being formed to advise Canada's trade negotiators. Labor has an important contribution to make by ensuring that the bilateral trade negotiations take account of labor's concerns about the future of manufacturing industries and of Canada's social and industrial policies. A diversity of views exists within the labor movement. For example, some labor leaders have indicated that if certain conditions were met, they would support a bilateral trade agreement.[3] Fears about job losses from adjustments that an agreement might require are understandable. But so are the fears of job losses in industries whose access to U.S. markets is currently limited or threatened by U.S. protectionism.

Conclusion

Groundwork has been laid in important policy areas for major change to occur in 1986. Governments must identify the national interest and adopt a vision of the future that is consistent with economic realities and a rising standard of living. They cannot create the vision by themselves, however, nor are they just referees among special interests. The nation must rise above narrow interests to engage in a cooperative endeavor that is larger than all of its parts. If it can do this, 1986 could be a year of unique accomplishment in securing Canada's long-term growth prospects.

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[3]J. Munro, President, Western Canadian Regional Council no. 1, International Woodworkers of America, Statement to the Special Committee on Canadian International Relations, Vancouver, July 29, 1985; and J. McCambly, President, Canadian Federation of labour, Remarks to the Ontario Provincial Council, Toronto, November 20, 1985.

Appendix

Table A1
Employment Gains and Losses by Industry, 1974–82
(percentage of 1974 base employment)

	Gains			Losses			
Industry	**Births**	**Expansions**	**Total**	**Deaths**	**Contractions**	**Total**	**Net change**
Business services	157.7%	50.0%	207.7%	35.4%	12.8%	48.2%	159.4%
Social services	96.6	21.0	117.6	20.0	7.4	27.4	90.2
Professional services	97.3	31.4	128.7	30.1	11.3	41.4	87.3
Amusement/ recreation	86.5	28.5	115.0	28.2	12.7	40.9	74.1
Mining	75.7	19.4	94.1	31.8	10.8	42.6	52.6
Accommodation	76.4	20.7	97.1	33.6	11.4	45.0	52.0
Finance	68.7	24.8	93.5	28.5	15.4	43.9	49.6
Agriculture	54.5	29.1	83.6	24.6	14.5	39.1	44.5
Health services	23.1	31.5	54.6	5.6	5.1	10.7	44.0
Miscellaneous services	60.1	23.1	83.2	29.4	12.1	41.5	41.7
Transport	45.8	29.3	75.1	21.3	17.2	38.5	36.6
Trade	44.7	19.1	63.8	30.8	11.4	42.2	21.7
Forestry	47.7	21.7	69.4	32.1	18.0	50.1	19.2
Education	15.2	23.5	38.7	8.9	11.6	20.5	18.2
Construction	47.2	20.8	68.0	21.3	17.2	38.5	14.8
Manufacturing	30.7	17.7	48.4	28.6	12.5	41.1	7.3
Personal services	39.4	12.4	51.8	31.0	14.1	45.1	6.7
All industries	*45.2*	*20.9*	*66.1*	*28.4*	*13.0*	*41.4*	*24.7*

Source: Based on data from Department of Regional Industrial Expansion, *A Study of Job Creation in Canada, 1974–82* (Ottawa, 1985).

Table A2
Employment Gains and Losses by Province, 1974–82
(percentage of 1974 base employment)

	Gains			Losses			
Province	**Births**	**Expansions**	**Total**	**Deaths**	**Contractions**	**Total**	**Net change**
Alberta	95.6%	38.1%	133.7%	28.9%	9.9%	38.8%	94.8%
Saskatchewan	71.0	33.9	104.9	25.4	9.7	35.1	69.8
Yukon/N.W.T.	73.0	24.5	97.5	30.9	10.3	41.2	56.3
British Columbia	59.4	22.2	81.6	29.4	13.8	43.2	38.5
Newfoundland	55.9	17.8	73.7	27.2	14.1	41.3	32.4
Manitoba	42.3	22.1	64.4	25.2	22.1	39.9	24.5
Nova Scotia	46.4	18.0	64.4	26.3	18.0	41.3	23.1
P.E.I.	42.9	18.1	61.0	22.4	13.4	38.9	22.1
New Brunswick	43.4	18.9	62.3	27.7	18.3	41.1	21.2
Ontario	38.2	18.3	56.5	28.6	18.3	41.1	15.4
Quebec	36.6	19.6	56.2	28.6	14.0	42.6	13.7
Canada	*45.2*	*20.9*	*66.1*	*28.4*	*13.0*	*41.4*	*24.7*

Source: Based on data from Department of Regional Industrial Expansion, *A Study of Job Creation in Canada, 1974–82* (Ottawa, 1985).

Table A3
Employment Gains and Losses in Manufacturing by Province, 1974–82
(percentage of 1974 base employment)

	Gains			Losses			
Province	**Births**	**Expansions**	**Total**	**Deaths**	**Contractions**	**Total**	**Net change**
Newfoundland	63.3%	18.4%	81.7%	31.4%	8.8%	40.2%	41.5%
Alberta	58.6	28.4	87.0	34.8	11.4	46.2	40.8
Saskatchewan	43.3	22.4	65.7	24.4	10.7	35.1	30.5
P.E.I.	40.6	19.0	69.6	29.4	14.9	44.3	25.3
British Columbia	41.4	22.4	63.8	29.9	10.1	40.0	23.7
Yukon/N.W.T.	44.2	19.4	63.6	35.4	12.6	48.0	15.6
Manitoba	28.7	18.7	47.4	27.0	11.0	38.0	9.4
Ontario	30.7	16.1	46.8	27.2	12.1	39.3	7.5
Nova Scotia	30.9	18.2	49.1	28.9	14.0	42.9	6.2
New Brunswick	19.7	23.7	42.4	27.3	13.5	40.8	2.5
Quebec	25.0	17.3	42.3	30.3	14.0	44.3	-1.9
Canada	*30.7*	*17.7*	*48.4*	*28.6*	*12.5*	*41.1*	*7.3*

Source: Based on data from Department of Regional Industrial Expansion, *A Study of Job Creation in Canada, 1974–82* (Ottawa, 1985).

Policy Analysis Committee

The C.D. Howe Institute Policy Analysis Committee (HIPAC) was formed in 1980 from the Canadian Economic Policy Committee, established in 1961. This change was brought about to help streamline the Institute's activities and to improve the process of accountability of staff to the Institute's members.

HIPAC's membership is drawn primarily from business and labor organizations that are members of the Institute. To encourage diversity of perspective, HIPAC also includes members from the academic world, from agricultural organizations, and from the professions. Two Regional Advisory Committees have been established across the country to assist HIPAC in determining its research agenda and to ensure that the research conducted by the Institute on its behalf is relevant and reflective of regional points of view.

Full meetings of HIPAC's membership are held twice each year. The purposes of these meetings are to hear expert speakers on current policies, to engage in frank discussion of topics raised by members, and to identify a research program that the Institute can carry out effectively to improve public understanding of important policy issues. The professional completion of this program is then supervised by the Institute, which coordinates with the HIPAC Executive Committee.

The Chairman of HIPAC is H.A. Hampson (President and Chief Executive Officer, Canada Development Corporation).

Recent publications prepared in conjunction with HIPAC include:

- *Keeping an Eye on the Bail*, C.D. Howe Institute Commentary, by Wendy Dobson (September 1985).
- *Budget Reform: Should There Be a Capital Budget for the Public Sector?*, Policy Commentary no. 6, by D.A.L. Auld (August 1985).
- *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27, by Richard G. Lipsey and Murray G. Smith (May 1985).
- *The Federal Budget: All Things to All People?*, C.D. Howe Institute Commentary, by Edward A. Carmichael and Wendy Dobson (April 1985).
- *Policy Review and Outlook, 1985: Time for Decisions*, by Edward A. Carmichael (February 1985).
- *Education Policy in Canada: The Urgent Issues*, C.D. Howe Institute Commentary, by Claude E. Forget (February 1985).